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TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

H.R. 4961

together with

ADDITIONAL SUPPLEMENTAL AND MINORITY VIEWS

JULY 12, 1982.—Ordered to be printed

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97TH CONGRESS
2d Session

SENATE

REPT. 97-494
Vol. 1

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

JULY 12, 1982.—Ordered to be printed

Mr. DOLE, from the Committee on Finance,
submitted the following

REPORT

together with

ADDITIONAL SUPPLEMENTAL AND MINORITY VIEWS

[To accompany H.R. 4961]

The Committee on Finance, to which was referred the bill (H.R. 4961) to make miscellaneous changes in the tax laws, having considered the same, reports favorably thereon with amendments and an amendment to the title and recommends that the bill as amended do pass.

PART ONE:
SPENDING REDUCTION PROVISIONS

[Finance Committee Amendment to H.R. 4961]

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FINANCE COMMITTEE RECOMMENDATIONS—SUMMARY TABLE OF COST SAVINGS

[Outlays in millions of dollars]

Provision	Fiscal year— 1983	1984	1985	3-year total
Medicare:				
Delay initial eligibility	170	230	270	670
Working aged	350	530	600	1,480
Home health copayments	35	65	75	175
Radiology and pathology reimbursement	160	210	250	620
Part B deductible	65	155	255	475
Limitation on economic index	230	390	460	1,080
Repeal nursing differential	95	110	125	330
Payments to provider-based physicians	63	73	84	220
Part B premium	36	204	499	739
223 limits on total costs and limit rate of increase in Medicare revenues	610	1,720	3,120	5,450
Regulations:				
Eliminate private room subsidy	54	75	80	209
SNF and HHA services	18	46	46	110
Duplicate payments for outpatient services	160	225	270	655
Provider cost report audits	130	300	300	730
Periodic interim payment	750	100	–870	–20
Assistants at surgery	55	130	150	335
Judicial review	0	0	0	0
Ineffective drugs	0	0	0	0
Payments to HMO's	0	0	0	0
Medicare subtotal	2,981	4,563	5,714	13,258
Medicaid:				
Allow States to require nominal copayments	42	47	53	142
Eliminate matching for medicare Part B buy-in	203	216	230	649
Allow States to apply liens	183	200	221	604
Reduce error rate tolerance	30	65	72	167
Medicare changes	30	80	140	250
AFDC changes	100	130	170	400
Medicaid subtotal	588	738	886	2,212
Utilization and Quality Control Peer Review:				
Peer review	15	15	20	50
Health subtotal	3,584	5,316	6,620	15,520

FINANCE COMMITTEE RECOMMENDATIONS—SUMMARY TABLE OF COST SAVINGS—Continued

[Outlays in millions of dollars]

Provision	Fiscal year— 1983	1984	1985	3-year total
AFDC:				
Round benefits	9	10	10	29
Prorate 1st month's benefit	13	14	14	41
Eliminate uniformed service as reason for AFDC	15	17	17	49
Refusal to work	1	1	1	3
Mandatory job search	20	50	50	120
End parent benefit when child is 16	47	48	48	143
Include all minor children (except SSI)	63	64	64	191
Count income of unrelated adults	69	70	70	209
Repeal emergency assistance	60	60	60	180
Prorating for shelter and utilities	43	44	45	132
Reduce error rate match	85	129	41	255
AFDC receipt by minor children	25	27	29	81
Retrospective accounting				
Reopen WIN demonstration authority				
AFDC subtotal	450	534	449	1,433
Child support enforcement:				
Modified collection fee for non-AFDC cases	12	16	11	39
Child support allotments for Armed Forces	7	9	10	26
Reimbursement of State agency	3	4	4	11
CSE subtotal	22	29	25	76
Supplemental security income:				
Prorate 1st month's benefit	26	28	32	86
Round benefits	20	25	30	75
COLA coordination	45	41	43	129
Hold harmless phaseout	30	37	45	112
Recovery of overpayments	16	17	18	51
SSI subtotal	137	148	168	453
Unemployment compensation:				
Round benefits	0	10	19	29
Unemployment compensation subtotal	0	10	19	29
Grand total	4,193	6,037	7,281	17,511

II. Summary of Spending Reduction Provisions

A. Medicare Provisions

Delay initial eligibility date for Medicare entitlement.—The initial eligibility date would be delayed from the first day of the month in which the individual turns 65 to the first day of the following month.

Modify coverage of the working aged.—Employers would be required to offer employees aged 65 through age 69 the same health benefit plan offered to younger workers and Medicare would be a secondary payor to these plans.

Require minimal copayments on home health services under Medicare.—Home health services would be subject to copayments equal to 5 percent of the average reasonable cost per visit.

Reimburse inpatient radiology and pathology services at 80 percent of reasonable charges.—The special 100 percent reimbursement rate for inpatient radiology and pathology services would be eliminated. Such services would be paid for on the same basis as other physicians' services.

Index part B deductible to the Consumer Price Index (CPI).—The Part B deductible would be indexed to the CPI beginning in 1983. As a result the deductible is estimated to be $80 in 1983, $85 in 1984, and $89 in 1985.

Provide for no increase in physician fee economic index.—No increase would be allowed in the economic index for fiscal year 1983 and only a 5-percent increase will be permitted in fiscal year 1984.

Repeal routine nursing salary cost differential.—The differential factor paid to hospitals and skilled nursing facilities for inpatient routine nursing salary costs would be eliminated.

Payments for services of provider-based physicians.—The Secretary of HHS would be directed to prescribe regulations which would distinguish between the services of hospital-based physicians which are covered under medicare on a reasonable cost basis and those which are reimbursable on the basis of reasonable charges; and establish standards of reasonableness to be applied in each case.

Hold part B premium constant as a percentage of program costs.—The part B premium paid by enrollees in the Supplementary Medical Insurance program would be set and maintained at 25 percent of part B program costs.

Limit Medicare reimbursement to hospitals.—The current limits on Medicare reimbursement to hospitals (i.e., the section 223 limits) would be extended and modified to include ancillary operating costs and special care unit operating costs; annual increases in the overall operating costs per case would be limited (for a period of not more than 3 years); and the Secretary of HHS would be directed to develop methods under which hospitals, skilled nursing facilities and other providers could be paid on a prospective basis.

Require certain Medicare regulations.—The Secretary of HHS would be required to issue regulations to (a) eliminate the private room subsidy for hospitals, (b) establish single reimbursement limits for skilled nursing facility and home health agency services, and (c) eliminate duplicate overhead payments for outpatient services.

Audit and medical claims review.—The Medicare contracting budget for fiscal years 1983, 1984, and 1985 would be supplemented by $45 million in each year to be spent specifically for audit and medical review activities.

Temporarily delay the periodic interim payment (PIP).—Periodic interim payments to hospitals for the latter part of September 1983 would be delayed until October 1983. There would be a similar deferral of PIP payments from September to October of 1984.

Assistants at surgery.—Reimbursement for assistants at surgery in hospitals where a training program exists in that specialty would be prohibited, except in the case of exceptional circumstances.

Judicial district in which providers may obtain judicial review.—Federal judicial review of an adverse decision of the Provider Reimbursement Review Board involving actions brought jointly by several providers of Medicare services could be conducted by the U.S. District Court for the district where the "principal party" for the group is located.

Ineffective drug provision.—Payments under Medicare Part B and under Medicaid for ineffective drugs would be prohibited.

Medicare payments to HMO's.—Current requirements for contracting with health maintenance organizations (HMO's) would be modified by authorizing prospective reimbursement under risk sharing contracts with competitive medical plans (CMP's) at a rate equal to 95 percent of the Adjusted Average Per Capita Cost (AAPCC).

Technical corrections to Omnibus Budget Reconciliation Act of 1981.

B. Medicaid Provisions

Allow nominal Medicaid copayments.—The prohibition against nominal copayments for mandatory services to categorically eligible medicaid recipients would be repealed except in the case of certain inpatient hospital and ambulatory services for children and pregnant women and for services provided to inpatients in medical institutions who are required to spend, except for a personal needs allowance, all their income for medical expenses.

Eliminate matching for Medicare Part B "buy-in".—Federal matching for Part B premium payments for Medicaid recipients would be eliminated.

Modify lien provision.—States would be permitted under certain circumstances to attach the real property of Medicaid recipients who are permanently institutionalized in nursing homes or other long-term care medical institutions.

Reduce Medicaid error rates.—States would be required to reduce their Medicaid error rates to 3 percent.

Continuation of Medicaid eligibility.—States would be allowed the option of continuing Medicaid coverage for certain working families who were made ineligible for AFDC as a result of certain provisions of the 1981 Reconciliation Act.

Technical corrections to Omnibus Budget Reconciliation Act.

C. Utilization and Quality Control Peer Review

Contract for utilization and quality control peer review.—The Professional Standards Review Organizations (PSRO) program, would be repealed. The Secretary would be required to enter into contracts with peer review organizations for an initial period of 2 years, renewable biannually, for the purpose of promoting effective, efficient, and economical delivery of health care under Medicare.

D. Aid to Families With Dependent Children (AFDC) Provisions

Rounding of eligibility and benefit amounts.—States would be required to round both their need standards and actual monthly benefit amounts to the next lower whole dollar.

Proration of first month's benefit.—Therefor the monthly application AFDC benefit would be prorated from the date of application.

Eliminate uniformed service as basis for AFDC eligibility.—Absence from the home solely because of uniformed service would be excluded as a basis for AFDC eligibility.

Refusal to work.—Sanctions would be imposed on individuals who refuse work, reduce hours of employment, or terminate employment, without good cause.

Mandatory job search.—Individuals applying for AFDC benefits would be required to participate in job search while the application is pending. Continued job search would be required, after the application becomes effective, for not more than a total of 8 weeks each year.

Inclusion and exclusion of specified individuals' needs and income.—The Federal statute would define those individuals whose needs and incomes must be included or excluded from the AFDC filing unit: (1) the employable parent's benefit would end when the youngest child reaches age 16; (2) all children would be included in the filing unit (except SSI disabled children and stepbrothers and stepsisters); and (3) the income of unrelated persons living in the AFDC household would be counted as available to the AFDC family.

Repeal of emergency assistance program.—The emergency assistance program would be repealed.

Proration for shelter and utilities.—States would be allowed to prorate the portion of the AFDC grant for shelter and utilities for AFDC families living in households with other individuals.

Reduction of Federal match for payment errors.—The allowable error rate for AFDC would be 4 percent in fiscal year 1983, 3 percent in fiscal year 1984, and 3 percent in fiscal year 1985.

Households headed by minor parents.—To receive AFDC benefits, a minor parent and her child would have to reside in the home of the minor parent's own parent or guardian.

Exclusion from income of certain State payments.—States would be allowed to exclude from calculations of AFDC benefit amounts any payments made solely from State funds that are designed to compensate for lost income in the period before the new benefit amount can be calculated and paid.

Extension of time for States to establish a work incentive demonstration program.—States would be allowed two additional years in which to exercise their option to operate a WIN demonstration program (as provided in the 1981 Reconciliation Act).

E. Child Support Enforcement Provisions

Fee for services to non-AFDC families.—The law in effect prior to P.L. 97–35 would be restored which allows States to charge a reasonable fee for a non-AFDC collection and retain from the amount collected an amount equal to administrative costs not covered by the fee. As a State option, authority would be retained for States to collect from the parent who owes child or spousal support an amount to cover administrative costs, in addition to the child support payment.

Allotments from pay for child and spousal support owed by members of the uniformed services on active duty.—Allotments would be required from the pay and allowances of any member of the uniformed service, on active duty, when he fails to make child (or child and spousal) support payments.

Reimbursement of State agency in initial month of ineligibility for AFDC.—States would be permitted to reimburse themselves for AFDC that would have already been paid for months before the support was collected and known to make the family ineligible. Thus, the family would not receive double payment for the same month, both in the form of AFDC and through receipt of the support collection.

F. Supplemental Security Income Provisions

Prorate first month's benefit based upon date of application.—The first month's SSI benefit would be prorated from the date of application or the date of eligibility, whichever is later.

Round SSI eligibility and benefit amounts.—SSI monthly benefit and income eligibility amounts would be rounded to the next lower dollar. Rounding would take place after the cost of living adjustment had been made.

Coordination of SSI and OASDI cost-of-living adjustments.—The SSI and social security (OASDI) benefit increases would be coordinated so that at the time the cost-of-living adjustment is made, the recipient's SSI benefit would be based on his or her social security payment in the same month. Also, whenever the Secretary judges there to be reliable information on the recipient's income or resources in a given month, the SSI benefit in that month would be based on that information.

Phase out "hold harmless" protection.—Federal hold harmless payments would continue to be phased out, being reduced to 40 percent of what they would otherwise be in 1983, to 20 percent in 1984, with no "hold harmless" payments made in 1985 and future years.

Recovery of SSI overpayments.—The Secretary would be authorized to collect SSI overpayments from benefits payable under other programs administered by the Social Security Administration (Black Lung and OASDI benefits).

G. Unemployment Compensation Provisions

Round unemployment benefits to next lowest dollar.—The Federal 50 percent matching share of extended unemployment benefits would not be available on that part of extended unemployment benefit payments which result from a failure on the part of the State to have a benefit structure in which benefits are rounded down to the next lower dollar.

III. Description of Spending Reduction Provisions

A. PROVISIONS RELATED TO MEDICARE

DELAY INITIAL ELIGIBILITY DATE FOR MEDICARE ENTITLEMENT

(Section 101 of the Bill)

Present law.—Under current law, eligibility for Medicare begins on the first day of the month in which an individual reaches age 65. As a result, medicare often pays benefits for services that were provided before an individual reaches his 65th birthday.

Committee amendment.—The amendment defers eligibility for parts A and B of Medicare until the first day of the month following the month the individual attains age 65.

The committee believes that this amendment will not disrupt current health benefits coverage for the large majority of people, although some gaps may occur. The committee notes that some individuals may now be covered by health insurance policies in which coverage under such contracts terminates upon reaching age 65 or on the first day of the month in which they attain such age. The committee is concerned that such persons could find themselves with gaps in protection as a result of the provision to delay medicare coverage until the beginning of the month after reaching age 65. However, the committee believes that State insurance authorities, which are the responsible governmental authorities for regulating private insurance contract provisions, will take such steps as may be necessary to assure that private policies will be amended or adjusted to assure continuity of coverage under such plans until Medicare coverage begins. However, the committee notes that medicaid coverage will continue to be available to certain needy aged individuals during the brief period before their medicare coverage begins.

The committee directs the Secretary of HHS to make all reasonable efforts to inform individuals in advance of the date their medicare coverage begins, and, to the extent feasible, make sure that these people do not suffer undue hardships as a result of the deferral of medicare eligibility.

Effective date.—To be applied to individuals who attain age 65 after August 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$170
1984	230
1985	270

COORDINATION OF MEDICARE BENEFITS WITH REQUIRED HEALTH BENEFITS FOR EMPLOYEES AGE 65 TO 70

(Section 102 of the Bill)

Present law.—The Federal Age Discrimination in Employment Act (ADEA) prohibits employment bias on the basis of age between 40 and 70 for most workers in the private sector. However, the ADEA regulations permit an employer to "carve-out" from his health plan those benefits that are actually paid for by medicare. The employer's plan pays only for those expenses it insures against that are not paid for under the Government's program. As an alternative, an employer can offer employees eligible for medicare a separate plan that supplements medicare. However, the employer must assure: (1) that the costs of such a plan are not less than what would be expended to include such individuals in the regular employer plan with medicare "carve-out", and (2) that the supplemental plan when taken in combination with medicare provides benefits that are not less favorable than an employee eligible for medicare would receive under the employer's regular plan for other workers. The regulations further provide that if the employer's regular plan requires no employee contribution or an amount less than that required for part B coverage under medicare, the employer must pay or contribute toward the part B contribution so as to make the total benefits available no less favorable for employees over 65 than for workers under 65.

Additionally, except in certain specified circumstances, present law provides that the Medicare program pays benefits to which covered individuals are entitled without regard to any other sources of payment to which such persons may also be entitled. Medicare, in other words, is the "primary" or first payor of benefits in dual coverage situations. Medicare is the "secondary" payor of benefits only in circumstances involving workmen's compensation cases, in instances where payment can be made under an automobile or liability insurance policy or plan or under no-fault insurance, and where benefits are payable under an employer group health plan for services furnished to end-stage renal disease beneficiaries during a period of up to twelve months.

Committee amendment.—The committee amendment coordinates the benefits under the Medicare program with health benefits for employees (and their spouses) age 65 through age 69, in group health benefits plans sponsored by employers of 20 or more regular employees.

Under the amendment, Medicare's payment for any item or service furnished to an employee (or his spouse), would be reduced where the combined payment under Medicare and the employer's health benefits plan would otherwise exceed, (1) for items or services reimbursed on a cost or cost-related basis, their reasonable cost, or, (2) for items reimbursed on a charge basis, the higher of the reasonable charge (or other amount payable under Medicare, without regard to the program deductibles or coinsurance) or the amount payable under the employer group plan (without regard to deductibles or coinsurance imposed under that plan). In no case would Medicare pay more than Medicare would have paid in the absence of any employer plan coverage.

The coordination of benefits provision would apply if payment has been made, or can reasonably be expected to be made (as determined by the Secretary in regulations), for any item or service on behalf of an employee who has reached the calendar month following the month in which he attains age 65, but is under age 70 (or on behalf of the spouse of the employee, if the spouse has reached the calendar month following the month in which the spouse attains age 65 and is under age 70). Coordination of benefits would only occur in the case of health benefits plans related to the employee's employment, and not in the case of any other health benefits to which the employee (or his spouse) may be entitled, individually or under some other group arrangement. The Secretary could waive the provisions of this amendment in the case of individual claims where he determines that the probability of recovery or the amounts involved do not warrant pursuing such claims. The committee expects that the Secretary will establish in regulations rules regarding minimum amounts recoverable and the procedures for seeking recovery from employer plans similar to those employed by Medicare in other instances where Medicare is the secondary payor.

The amendment would not apply in the case of any employer health benefits plan offered by employers employing les than 20 full-time employees (regardless of the number of employees and family members actually enrolled in the plan). The committee intends that the Secretary issue regulations prescribing the definition of a "full-time" employee and the methods to be used to determine whether or not this provision applies to specific employers and employer health benefit plans. The committee believes that changes in the primacy relationship between Medicare and employer-based plans should not extend to small businesses, which often employ many older workers as a significant part of their total work force. Increases in the fringe benefit costs of these employers could discourage them from continuing to hire or to retain older workers in their jobs.

The committee amendment amends the Age Discrimination in Employment Act by requiring an employer to offer his employees age 40 or over but under age 70 (and their dependents) the same health benefits offered the employer's younger employees (and their dependents). Employers must offer these benefits as primary to benefits under Medicare for employees (and their spouses) age 65 and over, but under age 70. While the employer must offer the coverage the employee may choose not to participate in the employers plan.

Effective date.—January 1, 1983.

Estimated savings.—

Fiscal years:	*Millions*
1983	$350
1984	530
1985	600

REQUIRE MINIMAL COPAYMENT ON HOME HEALTH SERVICES UNDER MEDICARE

(Section 103 of the Bill)

Present law.—Under current law, an unlimited number of home health visits are covered without a deductible or coinsurance provided certain conditions are met. Public Law 96–499 eliminated the requirement, that home health services covered under part B be subject to the annual deductible. The law also removed the 100-visit limit under parts A and B on the number of home health visits that medicare will cover, and the requirements for prior hospitalization.

Committee amendment.—The amendment imposes a specified copayment amount (recalculated annually) for all home health visits. The uniform nationwide copayment amount is to be equal to five percent of the estimated average reasonable cost per visit rounded to the nearest dollar. The nationwide copayment amount for calendar year 1983 is estimated at $2.00.

Prior to 1973 home health benefits payable under Part B of Medicare were subject to 20 percent coinsurance on the same basis as other Part B services. The Committee notes that the "Omnibus Reconciliation Act of 1980" (P.L. 96–499) significantly liberalized home health benefits under Medicare, by eliminating the limitation on the number of visits, deleting the prior hospitalization requirement, and eliminating the deductible for Part B benefits. The committee is concerned that there is currently no financial incentive for beneficiaries to use only needed services. The committee feels that the coinsurance charge imposed by this provision will provide this incentive while not imposing an unreasonable hardship on beneficiaries.

Effective date.—January 1, 1983.

Estimated savings.—

Fiscal years:	Millions
1983	$35
1984	65
1985	75

REIMBURSEMENT FOR SERVICES OF RADIOLOGISTS AND PATHOLOGISTS TO HOSPITAL INPATIENTS AT 80 PERCENT OF REASONABLE CHARGES

(Section 104 of the Bill)

Present law.—Part B of Medicare will pay 100 percent of the reasonable charges of radiologists and pathologists who furnish radiology and pathology services to hospital inpatients, if such physicians accept assignment on all claims for such patients. Such services are not subject to the deductible or coinsurance features of the Part B program.

Committee amendment.—Medicare will ordinarily reimburse 80 percent of the reasonable charges for physician and most other part B services after enrollees satisfy an annual deductible. Beneficiaries are responsible for the remaining 20 percent of the reasonable charges, known as the coinsurance, and any other amounts that exceed reasonable charges or which are for noncovered services. The committee amendment eliminates the special 100 percent reimbursement rate for inpatient services furnished by radiologists and pathologists who accept assignment in connection with claims for such services. Instead, Medicare would pay for such services on the same basis as other physicians services are now reimbursed, i.e., 80 percent of reasonable charges after the part B deductible has been met.

The 1967 Social Security Amendments modified the part B program to reimburse 100 percent of the reasonable charges for services furnished to hospital inpatients by physicians in the fields of radiology and pathology. This provision was intended to simplify reimbursement procedures and streamline claims processing by hospitals and intermediaries. It was also anticipated that combined billing by hospitals (on behalf of the physicians and the facilities) for radiological and pathological services would result in administrative savings both for those who used it and for the Medicare program. However, the 1967 change did not restrict the 100 percent payment feature only to radiologists and pathologists who billed through combined arrangements. During the 1970's, increasing numbers of such physicians billed patients directly on a fee-for-service basis. The Omnibus Reconciliation Act of 1980 further amended the special provisions relating to radiologists and pathologists by requiring these physicians to accept assignment as the quid pro quo for the waiver of the deductible and coinsurance features of the part B program.

Since the simplifications anticipated from combined billing arrangements have not materialized, and since the trend toward separate fee-for-service billing by radiologists and pathologists continues, there is no longer any justification for the special coinsurance exemption.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$160
1984	210
1985	250

INDEX PART B DEDUCTIBLE TO THE CONSUMER PRICE INDEX

(Section 105 of the Bill)

Present law.—Under Part B, beneficiaries are required to incur $75 annually in expenses for most covered medical services before the program will begin making payments. Public Law 97–35 increased this deductible amount from $60 (the level it had been at since 1973) to $75 effective in calendar year 1982.

Committee amendment.—The amendment indexes the part B deductible to the Consumer Price Index (CPI) beginning in calendar year 1983. The deductible is to be equal to $75 multiplied by the ratio of the CPI for all urban consumers (U.S. city average) for the preceding July to such CPI for July 1981 and rounded to the nearest dollar. As a result, the deductible is estimated to be $80 in 1983, $85 in 1984, $89 in 1985. Indexing the Part B deductible as in the case of the Part A deductible, would preserve initial beneficiary liability for medical services in real terms. Such indexing would more closely link the deductible amount to the increases in program costs.

Effective date.—With respect to deductibles beginning in calendar year 1983.

Estimated savings.—

Fiscal years:	Millions
1983	$65
1984	155
1985	255

PROVIDE FOR NO INCREASE IN PHYSICIAN FEE ECONOMIC INDEX

(Section 106 of the Bill)

Present law.—Under Medicare Part B, charges billed by physicians that are recognized for reimbursement purposes as "reasonable charges" are limited by customary and prevailing charge screens which are updated every July 1. As a result of legislation enacted in 1972 annual increases in prevailing charge screens cannot exceed annual increases in an economic index. The economic index reflects increases in input costs for physicians' services and general earnings increases. The increase for the 12-month period beginning July 1, 1982 is 8.9 percent.

Committee amendment.—The amendment provides that the increase in the economic index effective July 1, 1982 would not be in effect for charges for services rendered on or after the effective date of the provision. The increase allowed for the 12-month period beginning July 1, 1983 could not exceed five percent. Physicians with customary charges below the new prevailing charge levels could have their reasonable charge increased up to the new prevailings.

Physician service fees rose by 11 percent in 1981. For this reason physicians must be expected to bear part of the burden of limits on program growth. The committee expects cost savings to be borne by institutions, physicians, and beneficiaries. The committee does not expect beneficiaries to increase their out-of-pocket expenses for medical services unless providers and physicians are also directly affected by the committee's cost savings provisions.

Effective date.—Applicable to charges for services rendered on or after October 1, 1982.

Estimated savings.—

Fiscal years:	Millions
1983	$230
1984	390
1985	460

REPEAL ROUTINE NURSING SALARY COST DIFFERENTIAL

(Section 107 of the Bill)

Present law.—By law, Medicare reimburses hospitals and skilled nursing facilities on the basis of their "reasonable costs." Since July

1969, the Secretary has paid a plus factor for inpatient routine nursing salary costs on the theory that older patients require more nursing care than younger patients. This plus factor was initially 8½ percent. Public Law 97–35 reduced, effective October 1, 1981, the inpatient routine nursing salary cost differential to 5 percent with respect to hospital services.

Public Law 97–35 also directed the Comptroller General to study the extent (if any) to which the average cost of efficiently providing routine inpatient nursing care to Medicare beneficiaries exceeds the average cost of providing such care to other patients.

Committee amendment.—The amendment deletes the routine nursing salary cost differential paid to hospitals and SNF's effective October 1, 1982. The committee believes this differential is no longer necessary in view of the changes which have occurred since 1969 in the way services are furnished. For example, sicker patients have been shifted from general routine care areas to special care units (for which the more intensive nature of care is recognized in reimbursement calculations).

The General Accounting Office issued a report in January 1982 which reviewed the results of existing nursing differential studies. GAO stated that while the studies did not provide conclusive evidence for or against the existence of an industrywide differential, it believed that, on balance, evidence tended to be against its existence. The GAO stated that to obtain conclusive evidence it would need to conduct a work-sampling study in routine nursing care units in a nationwide sample of hospitals. The projected cost of such a study is $8.3 million.

The committee does not feel, based on existing information, that there is a compelling reason for the differential. The amendment therefore provides for its repeal.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$95
1984	110
1985	125

PAYMENT FOR SERVICES OF PROVIDER BASED PHYSICIANS

(Section 108 of the Bill)

Present law.—Hospitals and skilled nursing facilities retain or employ various kinds of physicians, such as radiologists, anesthesiologists and pathologists, who provide numerous services for the institution itself in addition to direct patient care services. The services that these hospital-based physicians perform for the institution may include supervision of professional or technical personnel in certain hospital departments (e.g., laboratory or X-ray departments), research, teaching or administration. These practitioners negotiate a variety of financial agreements with hospitals and skilled nursing facilities regarding the services rendered by them in the provider setting.

Under current law and regulations, services furnished by a physician to hospital inpatients are reimbursed on the basis of reasonable charges under part B only if such services are identifiable professional services to patients that require performance by physicians in person and which contribute to the diagnosis or treatment of individual patients. All other services performed for the hospital (or for a skilled nursing facility) by provider-based specialists (e.g., radiologists, anesthesiologists, pathologists) are to be reimbursed as provider services on the basis of reasonable costs.

Committee amendment.—While the above policy has been established by the law and by regulation since the inception of the medicare program, it has never been uniformly implemented. As a result the amounts that the program has paid to some hospital based physicians are related to the amount of work performed by hospital employees rather than by the physician himself.

The committee amendment directs the Secretary of Health and Human Services to prescribe regulations, effective no later than October 1, 1982, which will distinguish between (1) professional medical services which require performance of the physician in person and which are personally rendered to individual patients and which contribute to the patients' diagnosis and treatment and are reimbursable only under part B and (2) the professional medical services of practitioners which are of benefit to patients generally and which can be reimbursed only on a reasonable cost basis. The Secretary would be expected to prescribe specific conditions, appropriate to each of the physician specialties, to establish when a practitioner's involvement in a patient care service is adequate to justify treating it as a physician service which is reimbursable on a reasonable charge basis under the part B program.

Medicare reimbursement for the services that would be covered under the respective parts of the program would be subject to appropriate tests of reasonableness.

As in the case of other physicians, services that are reimbursable on a reasonable charge basis will be subject to the customary-and-prevailing charge limits established under Part B of medicare. Similarly the compensation for supervision, teaching, administration and other professional services that would be reimbursable on a reasonable cost basis would be evaluated in terms of time that the physician expends, compensation comparability, and such other factors as the Secretary may prescribe.

The commiteee directs the Secretary to monitor changes in arrangements, patterns of service and hospital physician relationships as a result of this proposal.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$63
1984	73
1985	84

HOLD PART B PREMIUM CONSTANT AS A PERCENTAGE OF PROGRAM COSTS

(Section 109 of the Bill)

Present law.—Individuals who elect to be covered under the Supplementary Medical Insurance Program (part B), are required to pay a monthly premium. The amount of the premium which is set annually is $12.20, effective July 1, 1982.

Prior to July 1973, the Secretary annually determined the premium rate by estimating the amount necessary to meet one-half of the benefits provided to the aged, the administrative costs payable from the part B trust fund for the applicable 12-month period, plus a contingency reserve. The Federal Government appropriated out of general revenues a contribution equal to the total of the premiums paid by the elderly to finance the remaining half of the Supplementary Medical Insurance program's costs. The Federal share was not limited to the amount paid by premiums—if the premium estimate was too low, Federal revenues made up the difference.

The "Social Security Amendments of 1972" (P.L. 92–603) and subsequent amendments modified the method by which premiums were calculated to limit increases in premium amounts to the percentage by which monthly cash benefits increased in the interval since the premium had been last increased. Under current law, the Secretary is required to calculate each December the premium amount for the aged, to be effective the following July. The new premium rate is the lower of: (a) an amount sufficient to cover one-half of the benefits for the aged plus administrative costs, and a contingency amount (i.e., the actuarial rate); or (b) the current premium amount increased by the percentage by which social security cash benefits increase during the period between May of the current year and the following May (i.e., the standard rate). The premium rate calculated for the aged is also paid by disability beneficiaries. who are under age 65, even though they have higher health costs than the elderly.

Since 1974 the actuarial rate per aged enrollee has increased from $6.30 per month to $24.60 per month. The standard rate, however, only increased from $6.30 to $12.20. In announcing the rate to be effective July 1, 1982, the Secretary estimated that beneficiary premium contributions from the aged will be equal to 24.8 percent of anticipated part B costs for the aged.

Committee amendment.—The committee amendment establishes and maintains the Part B premium paid by aged enrollees at 25 percent of program costs. Disabled enrollees would continue to pay the same premium amounts as the aged. The premium amount for the 12-month period beginning July 1, 1982, would be adjusted to $12.30 on October 1. 1982, an increase of $0.10 over the current amount.

Effective date.—Premiums paid on or after October 1, 1982.

Estimated savings.—

Fiscal years:	Millions
1983	$36
1984	204
1985	499

LIMIT MEDICARE REIMBURSEMENT TO HOSPITALS

(Section 110 of the Bill)

Present law.—Under present law and regulations, Medicare reimburses hospitals (as well as skilled nursing facilities and home health agencies) on the basis of the "reasonable costs" they incur in providing covered services to beneficiaries, excluding any part of such costs found to be unnecessary in the efficient delivery of needed services. Reimbursement for hospital routine operating costs (i.e., bed, board and routine nursing care) may not exceed a limit (known as the Sec. 223 limit) based on similar costs incurred by comparably situated hospitals. Under this limitation, a hospital may not be reimbursed for more than 108 percent of the average routine cost per day incurred by other hospitals of the same type, unless it qualifies for an exception or an exemption.

In brief the calculation of the section 223 limit involves: identifying the inpatient general routine operating costs for each hospital, adjusted for certain factors; calculating the mean (average) of the adjusted routine operating costs of the comparable hospitals in a group; applying the reimbursement limit (currently 108 percent) to the mean to establish a limit for each hospital grouping; and making certain adjustments to the limits when applied to individual hospitals. Inpatient routine per diem costs in excess of the applicable limits are not reimbursable by the Medicare program. If a hospital's allowable per diem costs are under the Sec. 223 limits, the facility is reimbursed for its reasonable costs.

Committee amendment.—Hospital spending has been increasing at double-digit rates for over a decade and much faster than the rates of inflation in the economy as a whole. Hospital spending accounts for over 70 percent of Medicare program expenditures and the persistently large increases in hospital costs are now threatening the financial soundness of the Hospital Insurance Trust Fund.

The committee amendment addresses the problem of Medicare program spending for hospital care by (a) expanding the existing section 223 limits on inpatient general routine per diem operating costs to hospital ancillary operating costs and special care unit operating costs as well, establishing an overall limit on hospital inpatient operating costs per case, (b) establishing a short-term, temporary limit on annual rates of increase in hospital reimbursement per case, and (c) the direction development of methods under which hospitals, skilled nursing facilities and other providers would be paid on the basis of prospectively established rates.

a. *Expansion of section 223 limits to include ancillary costs.*—The committee amendment modifies the existing section 223 limitations by: (1) exempting from the limits small (under 50 bed) rural hospitals; (2) extending the limits to include hospital ancillary operating costs (e.g., lab services, X-rays, drugs, etc.) and special care unit operating costs; (3) increasing the current limit from 108 percent to 110 percent; (4) applying the limit on an average operating cost-per-case basis; and (5) adjusting each facility's limit to take into account the needs of its particular patients compared to the needs of patients in other hospitals with which it is being compared (by making "case-mix" adjustments). The Secretary is expected to recalculate such adjustments periodically.

The Committee understands that initially the Secretary will need to rely on a currently available indicator of case mix complexity such as the system developed at Yale University. The committee expects that the Secretary will continue to evaluate possible method for adjusting for case mix and will adopt an improved method when it becomes available.

The limits will be applied to total inpatient operating costs per case, rather than inpatient routine operating costs per diem. The committee believes that, by including ancillary and special care unit operating costs under the section 223 limits, it will be possible to look at overall costs involved in caring for Medicare patients and will permit payment to be made on a per case rather than per-day basis, thereby removing any incentives to keep patients longer than absolutely necessary. The committee also believes that such information on the costs of care will assist in the development of a prospective payment system.

The committee expects that in most other respects the current methods used to develop limits on routine operating costs will form the basis for initial application of the new ' limits," e.g., hospitals will continue to be classified into comparison groups and factors such as area wage differences will be recognized.

Historical cost data updated to reflect average actual and anticipated cost increases, would be used to develop the cost limits. The measure used to determine anticipated cost increases will be a market basket measure of the prices paid by hospitals for supplies and services, plus 2 percentage points.

The current days of care adjustment now used in establishing the routine operating cost limits would be eliminated. A new exceptions basis would be established for changes in case mix caused by significant changes in a hospital's operation or organization (e.g., the addition of a new service). The Secretary would be required to retain exceptions from application of the limits for costs arising from: (1) the provision of atypical services required by patients, (2) extraordinary circumstances beyond the provider's control, (3) providers in areas of fluctuating population, (4) medical and paramedical education, (5) the provision of essential community hospital services, and (6) for unusual labor costs. Also the committee anticipates that the Secretary would continue to apply any other exemptions, exceptions and adjustments now allowed under the routine operating cost limits that he deems appropriate for the new overall limits on operating costs.

In no case would a hospital's reimbursable cost per case be reduced below the per case costs that were reimbursable by Medicare for the cost reporting period that immediately preceded the first reporting period subject to the new limits.

The Secretary is directed to determine the extent to which the new hospital reimbursement limits for certain public hospitals and other institutions including public benefit corporations, should be adjusted to take into account the extra costs that they necessarily incur in treating low-income patients. Such an adjustment if warranted would be made beginning with the first year the limit is in effect. It is recognized that it may not be possible to establish an appropriate adjustment in time to apply it prospectively. Therefore it may be necessary for the initial application of the adjustment to be made retroactively.

The Secretary would develop adjustments under this and the following section (b) to assure that the proposed limits would not be significantly compromised if a hospital reduces its costs by cutting back on the kinds of services it provides directly to its patients—e.g., by leasing out its clinical laboratory.

This part of the amendment would be effective for hospital accounting periods beginning on or after October 1, 1982.

b. *3-year limit on hospital reimbursement increases.*—Under present law, there is no limitation on the percentage by which a hospital's reimbursable costs may increase from year to year. The committee amendment provides that Medicare would not reimburse a hospital for operating costs incurred in any of the first three of its cost-reporting periods beginning on or after October 1, 1982, to the extent that they increase in excess of a specified percentage. The committee intends this provision as a short-term measure to hold down the rate of growth of hospital insurance benefits until a workable system of prospective hospital payments can be developed to replace the retrospective cost-based reimbursement system now used.

Under the amendment, the base period will be the cost reporting period immediately preceding the first cost reporting period to which the limit applies. The allowable annual rate of increase in inpatient operating costs per case will be the rate of increase in a market-basket measure of the prices paid by hospitals for supplies and services, plus 2 percentage points. For example, if a hospital reports its costs to Medicare on a calendar-year basis its cost ceiling for allowable costs per case in 1983 will represent an increase of not more than market basket plus 2 percent (10 percent approximately) over its allowable cost per case in 1982. Similarly, its allowable rate of increase per case for 1984 and 1985 could not increase in excess of market basket plus 2 percent above the limit calculated for the previous year. For the first 2 years the amendment is in effect, hospitals would be paid 25 percent of any otherwise allowable costs that are in excess of the rate of increase limit; no payment would be made for amounts in excess of the rate of increase limit during the third year. This rate of increase limit on Medicare reimbursement would expire at the end of the hospital's third post September 30, 1982, cost reporting period, unless a prospective payment system is put into place prior to that time, in which case this limit on Medicare reimbursement would cease upon implementation of the new system.

The Secretary will provide an exceptions process to take into account factors that would distort either a hospital's base period or rate of cost increase during the 3-year limit period. Examples of such factors include significant changes in a facility's case-mix in a particular year when compared to the base year or extraordinary circumstances beyond the facility's control.

This part of the amendment would be effective for reporting periods beginning on or after October 1, 1982 (but not to exceed 36 months for any hospital).

c. *Prospective payment for hospitals and skilled nursing facilities.*—Under present law, hospitals and skilled nursing facilities are paid on the basis of the costs they incur in caring for Medicare patients. While the limits in present law tend to penalize some inefficient institutions, no provision is made to allow efficient institutions to benefit. Also, the amount of a hospital's reimbursement cannot be accurately determined until sometime after the close of the cost-reporting period in which the costs were incurred. Therefore, hospitals are restricted in their ability to engage in sound financial planning.

The committee amendment directs the Department of Health and Human Services to develop, in consultation with the Senate Finance Committee and House Ways and Means Committee, legislative proposals under which hospitals, skilled nursing facilities and, if feasible, other providers would be paid on a prospective basis. Because of the committee's interest in prospective payment the results of the State Medicare reimbursement demonstration are of great interest. Full and complete evaluation of these demonstrations will provide necessary information for legislative decisions on Medicare reimbursement.

The Department would be required to report its recommendations no later than 5 months after the date of enactment.

Effective dates.—Note above description.

Estimated savings.—

Fiscal years:	*Millions*
1983	$610
1984	1,720
1985	3,120

REQUIRE CERTAIN MEDICARE REGULATIONS

(Sections 111–114 of the Bill)

The amendment requires the Secretary to issue regulations for the following regulatory initiatives included in the President's Fiscal Year 1983 Budget.

a. Elimination of private room subsidy

Present law.—Under current law, medicare covers semiprivate room accommodations in a hospital and skilled nursing facility, except where private accommodations are medically necessary or where semiprivate accommodations are unavailable. Medicare reimburses for such services on the basis of allowable reasonable cost. However, since Medicare currently bases its payments to hospitals on the basis of the average costs for all its accommodations, the reimbursement indirectly includes the additional costs of private rooms even though Medicare is only supposed to cover the cost of semiprivate rooms.

Committee amendment.—The amendment requires the Secretary to publish regulations which would eliminate the subsidy of the estimated extra cost of private rooms. Initially this may be accomplished by subtracting from a provider's allowable costs the estimated differential costs based on the differential charges for private rooms over semiprivate rooms. Medicare, however, will continue to pay the estimated private room differential cost for medically necessary private rooms used by program beneficiaries. The decrease in reimbursement as a result of this provision may not be passed along to beneficiaries.

Effective date.—Cost reporting periods beginning on or after October 1, 1982.

Estimated savings.—

Fiscal years:	Millions
1983	$54
1984	75
1985	80

b. Establish a single reimbursement limit for skilled nursing facility and home health agency services

Present law.—Under current law, the Secretary is authorized to set prospective reimbursement for providers of services under Medicare on the basis of estimates of the costs necessary for the efficient delivery of needed health services. Reimbursement limits for skilled nursing facilities (SNFs) have been established for inpatient general routine service costs. These limits are currently set at 112 percent of the average operating costs of each comparison group. Cost limits for home health agencies (HHAs) are set at the 75th percentile of average per visit cost for each group.

Allowable costs for services provided by skilled nursing facilities and by home health agencies generally vary depending on whether the skilled nursing or home health services are delivered through hospital-based or in free-standing facilities. Separate payment limits are currently established for services rendered in each type of setting.

Committee amendment.—The amendment requires the Secretary to modify existing regulations by establishing a single payment limit that would be based on the cost experience of free-standing facilities. The committee expects that this provision will encourage more efficient behavior on the part of hospital-based facilities. The Secretary would be authorized to establish adjustments or exceptions, as appropriate, based on legitimate cost differences in hospital-based facilities resulting from such factors as more complex case-mix or effects of medicare cost allocation requirements.

Effective dates.—HHA services, cost reporting periods beginning on or after the date of enactment; SNF services, cost accounting periods beginning on or after October 1, 1982.

Estimated savings.—

Fiscal years:	Millions
1983	$18
1984	46
1985	46

c. Eliminate duplicate overhead payments for outpatient services

Present law.—Public Law 97-35 required the Secretary, to the extent feasible, to establish, by regulation, limitations on costs or charges that are to be considered reasonable for outpatient services provided by hospitals or clinics (other than rural health clinics) and by physicians utilizing these facilities. Limitations are to be reasonably related to the actual charges (not Medicare-determined reasonable charges) in the same area for similar services provided in physicians' offices. Limitations are not to apply with respect to bona fide emergency services provided in hospital emergency rooms. Further, the legislation requires the Secretary to provide for exceptions to the limitations in cases where similar services are not generally available to Medicare beneficiaries in physicians' offices in the area.

The location where a physician's service is performed (i.e., physicians' office or hospital outpatient department) has an important bearing on whether there are overhead costs for which he is responsible. While a physician pays for his office overhead (e.g., utilities, nursing staff, etc.), similar costs for services he renders in an outpatient department are borne by the hospital and covered by the hospital's reimbursement.

Committee amendment.—The amendment requires the Secretary to issue regulations that would eliminate the duplicate payment of overhead expenses in cases where a physician performs services in a hospital's outpatient department. This would be achieved by reducing the prevailing charge screens to eliminate the overhead component. The Secretary is now required to calculate an overhead factor in order to determine the percentage by which physicians prevailing charges may increase under the economic index provisions. Currently, it is estimated that approximately 40 percent of physicians' fees are for overhead. The committee thus expects that refined prevailing charge screens for physicians who practice in settings where they are not personally responsible for overhead expenses will be reduced by the same percentage as that used in implementing the economic index. Medicare will continue to pay 80 percent of the reasonable charges that result from the revised screens.

Effective date.—Charges for services rendered on or after October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$160
1984	225
1985	270

AUDIT AND MEDICAL CLAIMS REVIEW

(Section 115 of the Bill)

Present law.—Under current law and regulations, Medicare contracts with intermediaries and carriers to perform a variety of day-to-day administrative and operational tasks for the program, including the review of claims and the conduct of audits.

Committee amendment.—The amendment requires that the Medicare contractor budgets for fiscal years 1983, 1984 and 1985 be supplemented by $45 million in each year to be spent specifically for contractor audit and medical review activities.

The fiscal year 1983 budget request for Medicare contracting is insufficient to assure adequate medical review and audit by intermediaries and carriers. As a result, the program stands to lose benefit dollar savings through a failure to identify improper billings and detect reported costs that are not reimbursable. The committee believes that adequate funding of medical review and audit activities is necessary if cost-effective program management is to be achieved. The committee intends that these funds not supplant funds that would otherwise be appropriated for these purposes, but rather that they supplement these amounts.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$130
1984	300
1985	300

TEMPORARILY DELAY PERIODIC INTERIM PAYMENTS

(Section 116 of the Bill)

Present law.—Under current reimbursement arrangements, hospitals receive payments for services provided to Medicare beneficiaries under one of two different procedures. Under the standard approach, hospitals submit bills and receive payments on the basis of such billings. The average timelag between the date of service and the date of payment under this approach is about 6 weeks. An alternative approach permits hospitals to receive periodic interim payments (PIP) which are not directly tied to the receipt of bills. On average, this payment procedure results in a 3-week lag between the rendering of services and the receipt of payment.

Committee amendment.—The amendment changes the periodic interim payment procedure by providing for a delay in the flow of PIP payments during September 1983, so that the lag for payments to hospitals that use this procedure will increase to about six weeks during the delay. The deferred payments would be paid to the hospitals affected by this delay in October 1983. The bill makes a similar deferral of PIP payments during September 1984.

The committee further recognizes that even so short an interruption in cash flow could cause substantial financial distress to providers with insufficient working capital and who are unable to obtain a short-term loan. This could be particularly critical for hospitals which receive a substantial portion of their revenues from the Medicare program. In these few cases, the committee expects the Secretary of HHS to utilize existing regulations which provide for accelerated payments for providers in financial difficulties.

To minimize hardship to hospitals affected by the proposal, the committee expects the deferred reimbursement amounts to be paid promptly in the new fiscal year, and that any interest expenses which hospitals are required to incur by hospitals as a result of borrowing to meet cash flow requirements during the deferral period will be included in such hospitals allowable costs.

Effective date.—September 1983.

Estimated savings.—

Fiscal years:	*Millions*
1983	$750
1984	100
1985	−870

ASSISTANTS AT SURGERY

(Section 117 of the Bill)

Present law.—Under current law and regulations, part B carriers are given discretion for reimbursing assistants at surgery (i.e., physicians who assist the primary surgeon during an operation). Generally speaking, the carriers follow local medical practice and/or private sector reimbursement policies.

Committee amendment.—Historically, many carriers have allowed assistants as surgery to bill fees (typically 20 percent of the primary surgeon's fee) only in hospitals in which approved residency training programs did not exist in that specialty. The rationale for not permitting assistants at surgery to bill fees in teaching hospitals has been that fully qualified house staff are available to serve in the capacity of assistants at surgery. Hospitals are reimbursed by Medicare on a reasonable cost basis for the salaries of such house staff. However, there has been a recent trend for carriers to allow charges for assistants at surgery who are not residents even in situations where a training program exists in that specialty.

The amendment would prohibit reasonable charge reimbursement for an assistant at surgery in hospitals where an approved training program exists in the specialty, except under the following exceptional circumstances: (1) the service is complex and requires performance by a team of physicians as in the case of coronary bypass operations, (2) the patient has multiple conditions which require the presence of and active care by a physician of another specialty during an operation, and (3) emergency situations or circumstances where qualified house staff is not available to assist at surgery. The Secretary is directed to define each of these situations more specifically. The Secretary is also directed to develop appropriate methods for reimbursement of assistants at surgery where their services are covered.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$55
1984	130
1985	150

JUDICIAL DISTRICT IN WHICH PROVIDERS MAY OBTAIN JUDICIAL REVIEW

(Section 118 of the Bill)

Present law.—Under existing law an individual provider of Medicare services may have an adverse decision of the Provider Reimbursement Review Board (PRRB) reviewed by the U.S. district court for the district in which the provider is located or, alternatively, in the U.S. district court for the District of Columbia. However, because of the language of the current medicare statute, actions brought jointly by several providers may be taken only in the U.S. District Court for the District of Columbia.

Committee amendment.—The amendment permits Federal judicial review of adverse decisions of the Provider Reimbursement Review Board involving actions brought jointly by several providers of medicare services to be conducted by the U.S. district court for the district where the "principal party" for the group is located. The committee expects that in defining "principal party," the Secretary's regulations would establish objective criteria that would prevent "forum shopping." Additionally the committee expects that, ordinarily, the principal party to a suit would be the providers' headquarters office, if the parties are commonly owned or, in the case of independent providers, the party with the most money at stake.

Effective date.—Enactment.

Estimated savings.—N.A.

REIMBURSEMENT FOR LESS THAN EFFECTIVE DRUGS

(Section 118 of the Bill)

Present law.—Section 2103 of the "Omnibus Budget Reconciliation Act of 1981" (P.L. 97–35) prohibited, effective October 1, 1981, the use of Federal funds under Medicare part B and under Medicaid to pay for certain drugs. These are ones that the Food and Drug Administration has proposed in a notice of opportunity for hearing, to withdraw from the market because they are less than effective; also included are identical, related, or similar drugs. Implementing regulations issued October 1, 1981 provided for a grace period until January 1, 1982 before enforcement of the provision. However, on October 23, 1981, in a lawsuit brought in the U.S. District Court for the District of Columbia, the court held that the Secretary was not authorized to grant a grace period; it ordered the Secretary to discontinue reimbursement for the subject drugs effective October 30, 1981.

Public Law 97–72, signed into law on December 15, 1981, continued appropriations for the government through March 31, 1982. This law incorporated by reference a provision in the appropriations bill passed by the House on October 6, 1981; the House provision provided that: "None of the funds appropriated or otherwise made available in this title may be used to pay the salaries of officers and employees for implementation or enforcement of section 2103 of the Omnibus Budget Reconciliation Act of 1981 or for the implementation or enforcement of rules or regulations pursuant to such section." The provision was approved by the Senate with the understanding that it would expire on April 1, 1982. However, the provision was automatically extended until September 30, 1982, when, on March 31, 1982, the President signed Public Law 97–161 which extended the effective date of Public Law 97–72 through September 30, 1982. The Department published a notice in the Federal Register on April 16, 1982 providing for the continued reimbursement of the subject drugs through September 30, 1982.

Committee amendment.—The amendment provides, effective on enactment, for implementation of Section 2103 of the "Omnibus Budget Reconciliation Act of 1981." The committee notes that the provision is intended to preclude Federal payments only for drugs which have been determined after careful review by the FDA to have been less than effective in use. The committee expects that the Department will devote sufficient resources to assure adequate implementation of the section.

Effective date.—October 1, 1982.

Estimated savings.—NA.

MEDICARE PAYMENTS TO HEALTH MAINTENANCE ORGANIZATIONS (HMO'S)

(Section 120 of the Bill)

Present law.—Health Maintenance Organizations (HMOs) are reimbursed by the Medicare program for services covered under both Parts A and B of Medicare according to the authority established in Sec. 1876 of the Social Security Act. Section 1876 defines an HMO as a legal entity which makes Medicade covered services available in a geographic area on a prepayment basis. At least one-half of an HMO's membership must be persons under age 65, although the Secretary is permitted to waive the 50 percent requirement for up to three years. All Medicare beneficiaries entitled to part A and/or B services, are eligible to enroll in an HMO serving the geographic area in which they live.

Under section 1876, HMOs receive interim monthly capitation payments for services furnished to Medicare beneficiaries according to one of two types of contracts, cost or risk. HMOs which are paid under cost contracts are reimbursed for the reasonable costs of providing covered services to Medicare enrollees according to Medicare's cost principles of cost reimbursement.

An HMO is eligible to enter into risk sharing contract if it is a mature HMO. A mature HMO is one which (1) has at least 25,000 members and which has served as the primary source of health care for at least 8,000 persons in the two years immediately preceding the contract, or (2) serves non-urban areas with current enrollments of not less than 5,000 members and which has served as the primary source of health care for at least 1,500 persons in the 3 years immediately preceding the contract. Under risk contracts, reimbursement is based on a comparison of the HMO's costs with its Adjusted Average Per Capita Cost (AAPCC), which is the average cost of providing services to Medicare beneficiaries in the same geographic area as the HMO but not enrolled, and having the same characteristics as the enrolled population. If the risk-based HMO's costs are less than the AAPCC, it shares the "savings" with the Medicare program and it may receive savings up to 10 percent of its AAPCC. HMO's are not required to provide additional benefits with their savings. If the HMO's costs are higher than its AAPCC, the HMO must absorb the loss, which may be carried forward and offset against future savings.

Committee amendment.—The committee amendment would amend section 1876 of the Social Security Act by authorizing prospective reimbursement under risk-sharing contracts for what are known as "competitive medical plans" (defined below) at a rate equal to 95 percent of the AAPCC. There would be no limit on the "savings" the plan could retain.

If the Secretary determines a competitive medical plan does not have the capacity to bear the risk of potential losses under a risk-sharing contract, or if it has less than 1,000 members, the plan must enter into a reasonable cost reimbursement contract under which reimbursement would be on the basis of reasonable cost. Other competitve medical plans may also elect to contract on a cost basis. As under current law monthly per capita payments to plans under such cost contracts would be subject to retroactive corrective adjustment, and certain financial data and administrative requirements would be required.

Under the committee amendment, Medicare payments would be made to a competitive medical plan with a risk-sharing contract on a per capita basis for each class of Medicare beneficiaries enrolled in the plan the classes of individuals would be based on factors including at a minimum, age, sex and disability status. The Secretary could add to. modify, or supplant these factors if such actions would add to the accuracy of the actuarial projection. In making an adqustment for disability status the Secretary may consider such factors as an individual's mental and physical condition, then prior utilization of health services and their ability to participate in activities for daily living. It is the Committee's intent that eligibility for cash payments under the Disability Insurance program or under SSI not be used as a determinent of disability status. The rate for each class would be 95 percent of the average per capita cost in the geographic area for individuals with similar characteristics but who receive services outside the plan. For an individual covered under a risk-sharing contract, only the plan (not the enrollee or any other person or entity) could receive Medicare reimbursement for services provided to enrolled Medicare beneficiaries.

The proposed amendment defines a "competitive medical plan" as a public or private entity, organized under the laws of any State, which is a qualified HMO (as defined in section 1310(d) of the Public Health Service Act), is a State-licensed HMO, or meets certain requirements, including providing to all its enrolled members; physician services, inpatient hospital services, laboratory, X-ray, and emergency services, and out of area coverage; being compensated (except for deductibles, coinsurance, and copayments) for the provision of health care services to enrolled members by a payment made on a periodic basis without regard to the date the health services are provided after the date of enrollment and the amount of which is fixed without regard to frequency, extent, or kind of health care services actually provided to a member; providing physicians' services through physicians who are employees or partners of the plan or through contracts with individual physicians or groups; assuming full financial risk, with certain exceptions, on a prospective basis for the provision of required health care services; and providing against the risk of insolvency.

Each competitve medical plan must provide to its Medicare enrollees at least the health services listed under parts A and B of Medicare which are available to indivduals residing in the geographic area served by the plan. Plans must have an open enrollment period of at least 30 days every year and must accept Medicare beneficiaries in the order in which they apply, with certain exceptions to be determined by the Secretary. A plan may not expel or refuse to reenroll an individual because of health status or requirements for health care. In addition, plans must reimburse for emergency services provided outside the plan; provide meaningful hearing and grievance procedures; have programs for review of medical care. In addition, at least one-half of its membership must be persons not entitled to Medicare or Medicaid benefits, except under certain circumstances.

Under the committee amendment, a plan's cost sharing requirements with respect to medicare covered services may not exceed the actuarial value of the coinsurance and deductibles which would be applicable to Medicare beneficiaries not enrolled in the plan.

The committee amendment also provides that if the adjusted community rate (defined as either the rate of payment for medicare covered services determined under a community rating system defined under the Public Health Service Act, or the portion of a plan's aggregate premium determined to be attributed to Medicare covered services adjusted for utilization differences between Medicare and non-Medicare enrollees) for services to enrolled Medicare beneficiaries is less than the AAPCC, the plan must use the differences to (1) provide additional benefits or services, (2) reduce premiums, deductibles or copayments, or (3) provide rebates or dividends to enrolled Medicare beneficiaries.

All individuals entitled to services under parts A and B, or part B only, of Medicare, except individuals medically determined to have end-stage renal disease, would be eligible to enroll with any plan which has a Medicare contract and serves the geographic area in which the individual resides.

In addition, under the committee amendment, three new Medicare members must enroll in a plan for every current Medicare enrollee allowed to convert to the new system. The proposal provides that the prospective payment system would not be effective until the later of the first day of the thirteenth month after enactment, or one month after the Secretary notifies the Senate Finance Committee and the House Committees on Ways and Means and Energy and Commerce that he is reasonably certain that the methodology for determining the prospective rate based on 95 percent of the AAPCC is developed and can be implemented.

Effective date.—Note above description.

Estimated savings.—NA.

B. PROVISIONS RELATED TO MEDICAID

ALLOW NOMINAL MEDICAID COPAYMENTS

(Section 131 of the Bill)

Present law.—Under current law, States are not permitted to impose cost-sharing charges on mandatory services provided to the categorically needy. They are permitted, but not required, to impose such charges on all services for the medically needy and on optional services for the categorically needy. All cost-sharing charges must be nominal in amount.

Committee amendment.—The amendment provides States with greater flexibility in administering their Medicaid programs by permitting them to impose nominal copayments on all beneficiaries for all services with certain exceptions. States would be precluded from imposing such charges with respect to: (1) inpatient hospital and the mandatory ambulatory services provided to categorically needy children and services related to the pregnancy of categorically eligible women; and (2) all services provided to categorically needy inpatients in medical institutions who are required to spend, except for a personal needs allowance, all their income for medical expenses. The committee recognizes that it may not be operationally feasible for States to ascertain in all cases whether recipients for whom claims are submitted were pregnant. The committee intends that copayments not be imposed with respect to the specified services when it can be determined from the provider's claim submitted for payment that the service provided was related to routine prenatal care, labor and delivery, routine postpartum care, complications of pregnancy or delivery or other medical conditions likely to affect the pregnancy (e.g., hypertension, diabetes, urinary tract infection).

The amendment permits States, at their option, to exempt two classes of individuals from any cost-sharing charges which the State chooses to impose. These two classes are: (1) inpatients in medical institutions, whether categorically needy or medically needy, who are required to spend, except for a personal needs allowance, all their income for medical expenses, and (2) medicaid recipients who are enrolled in health maintenance organizations. The committee notes that, for institutionalized individuals, cost-sharing for services other than those provided by the institution does not reduce the States' outlays for medical care and creates major administrative complexities. In addition, the committee believes it would be inequitable to require institutionalized individuals to pay cost-sharing charges out of their small personal needs allowance. The committee further recognizes that permitting States to exempt HMO enrollees from cost-sharing charges may simplify State negotiations with HMOs and may encourage more Medicaid recipients to enroll in HMOs.

The amendment provides that the cost-sharing imposed under this section is to be "nominal" in amount. The committee notes that existing regulations specify that the State can only impose one type of cost-sharing charge for each type of service. Currently for noninstitutional services, the following maximums are placed on allowable charges: (a) deductibles cannot exceed $2 per month per family; (b) coinsurance may not exceed 5 percent of the State's payments for the services; and (c) the maximum copayment chargeable to the recipient can range from $0.50 to $3.00 depending on the State's payment for such service. Currently for institutional services, the maximum beneficiary charge cannot exceed 50 percent of the payment the State agency makes for the first day of care in the institution. While not precluding changes in the current regulations, the committee expects similar maximum limits to be applied for the allowable charges permitted under this provision.

Further, the committee expects that the Secretary, in reviewing a State's proposed cost-sharing charges to determine if they are nominal, will consider the monthly amounts paid by the State as cash assistance under the State's AFDC program, and the income standards used to determine eligibility for the medically needy, as well as the costs of the specific medical services. Finally the amendment assures that recipients are not denied emergency care or other needed services because they are not able to pay required copayment amounts as a precondition to securing such services.

Effective date.—Enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$42
1984	47
1985	53

ELIMINATE MATCHING RATE FOR MEDICINE PART B "BUY-IN"

(Section 132 of the Bill)

Present law.—Most State Medicaid plans pay the monthly Medicare Part B premium payment for their dual eligible beneficiaries under a "buy-in" agreement. While States may buy-in to Medicare for both their cash assistance and medically needy populations who are eligible for Medicare federal matching for premium payments is available only for the cash assistance group. If a State does not buy in for Part B coverage, it cannot receive Federal matching payments for services that would have been covered under Medicare if there had been a buy-in arrangement. Four States and two jurisdictions do not currently have a buy-in arrangement. These are: Alaska, Louisiana, Oregon, Wyoming, the Northern Mariana Islands, and Puerto Rico. Alaska's buy-in agreement becomes effective October 1, 1982.

Committee amendment.—The amendment eliminates Federal matching for all Medicare Part B premium payments, effective with respect to premiums due for months after September 1982. The committee notes that the current combination of the 75 percent Federal general revenue subsidy for part B (for all Medicare part B eligibles) coupled with the Federal match for Medicaid eligibles results in a Federal subsidy of close to 90 percent for part B services for this population group.

Effective date.—Premiums due for months after September 1982.

Estimated savings.—

Fiscal years:	Millions
1983	$203
1984	216
1985	230

MODIFY LIEN PROVISIONS

(Section 133 of the Bill)

Present law.—Under current law, States are barred from imposing any lien against any recipient's property prior to his death because of

Medicaid claims paid or to be paid on his behalf unless placed as a result of a court judgment. In the case of individuals under age 65, no adjustments or recoveries can be made for Medicaid claims correctly paid. In the case of individuals over 65, adjustments and recoveries for correctly paid claims can only be made from his/her estate after the individual's death and only (1) after the death of his surviving spouse; and (2) where there are no surviving children who are under 21, blind, or disabled.

Further, under current law, States may deny medicaid eligibility to applicants who, within the previous 24 months, transferred for less than fair market value resources which, if retained, would have made them ineligible for the program. However, in most instances the applicant's ownership of a home would not make him or her ineligible for medicaid.

It is therefore possible, under current law, for an elderly individual who anticipates needing nursing home care to give his/her home to a family member or friend without fear of losing or being denied medicaid eligibility. By so doing, the individual assures that the home will not be part of his/her estate and therefore will not be subject to any recovery action initiated by the State after the individual's death.

Committee amendment.—The amendment intends to assure that all of the resources available to an institutionalized individual, including equity in a home, which are not needed for the support of a spouse or dependent children will be used to defray the costs of supporting the individual in the institution. In doing so, it seeks to balance government's legitimate desire to recover its medicaid costs against the individual's need to have the home available in the event discharge from the institution becomes feasible.

The amendment has two parts. First, it allows States to deny Medicaid eligibility temporarily to patients in medical institutions who dispose of a home for less than fair market value, even though such disposal would not make them ineligible for supplemental security income (SSI). States could either deny eligibility to all such individuals for periods reasonably related to the uncompensated value, or they could deny eligibility in all cases for a minimum of 24 months, with the option to provide for longer periods of ineligibility in the case of individuals who disposed of homes worth substantial amounts. The provision would not apply in the case of individuals who reasonably expected to be discharged from the medical institution and return home; individuals who demonstrated that they had intended to obtain fair market value or other valuable consideration in exchange for their homes; or individuals who transferred title to their homes to a spouse or a minor or handicapped child. The State could also make an exception in other cases where undue hardship would otherwise result.

Second, the amendment would allow States to attach the real property, including the home, of medicaid recipients who are permanently institutionalized in nursing homes or other long term care medical institutions. The lien could not be foreclosed upon, and States could recover the cost of medical assistance provided to the recipient only when the recipient voluntarily chose to sell the property or, after the recipient's death, from his estate. As under current law, no recovery would be permitted while the recipient's spouse was still living or while his/her children were still dependent (under 21, or blind, or disabled). Further, if the recipient is discharged from the institution and returns home, the lien would dissolve, and the property would be available for the recipient's use until his/her death.

The committee notes that, under current law, States are often unable to recover resources which recipients hold as homes or as income-producing real property. The amendment would facilitate States' efforts to recover medical assistance costs from these types of resources and to assure that all resources available to an individual will be used to defray the public costs of supporting that individual in a long-term medical institution.

At the same time, the committee notes that the legitimate rights of the recipient, the recipient's spouse and his/her dependent children are protected under the amendment.

Effective date.—Enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$183
1984	200
1985	221

REDUCTION IN ERROR RATE TOLERANCE

(Section 134 of the Bill)

Present law.—Under an amendment to the 1980 Appropriations Act, States were required to reduce their payment error rates for eligibility determinations to 4 percent by September 30, 1982. States whose error rates exceed the target figure are subject to a penalty reduction. The nationwide Medicaid payment error rate for the October 1980–March 1981 period was estimated at 4.1 percent.

Committee amendment.—The amendment deletes the error rate provisions and penalties incorporated in the 1980 Appropriations Act. It substitutes language establishing a 3 percent target error rate for quarters beginning after March 30, 1982. Prospective fiscal sanctions are to be applied beginning in the second half of fiscal year 1983 for States which have error rates exceeding the 3-percent figure. The annual penalty, applied on a prospective basis, will be equal to the product of (a) the portion of the projected error rate which exceeds 3 percent for the year in question and (b) the total amount of Federal financial participation expected to be claimed for the year for services provided to recipients for whom the State determined eligibility. If the estimated prospective penalty proves to be inaccurate when actual data from the period become available, appropriate adjustments will be made in subsequent grants. The Secretary is provided discretion in applying the fiscal penalties, in whole or part, for a State which has made a good faith effort to meet the 3-percent target.

The committee is aware that many questions remain to be resolved relative to the matter of sanctions for excessive rates of error. For example, under the existing provision no sanctions have in fact been imposed. However, the Administration's projections of program costs under present law appear to be based on an assumption that no waivers would be granted. The committee believes that the question cannot be predetermined either way but must be based on a case-by-case examination by the Secretary of the situation in a State, taking into account relevant circumstances including the question of whether the State has shown a sustained record of improvement over a period of years. The committee intends that the provision be administered in a way which will achieve its objectives on a reasonable basis. The purpose of the provision is to provide a strong incentive for improved program accuracy and to avoid Federal participation in erroneous payments which could have been avoided. The committee recognizes that there are limitations on what it is possible to accomplish even with good faith efforts aimed at full compliance.

The committee has delayed the effective date for imposition of fiscal sanctions until April 1983 in order to allow it time to study the existing quality control system.

Effective date.—Enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$30
1984	65
1985	72

CONTINUATION OF MEDICAID ELIGIBILITY

(Section 135 of the Bill)

Present law.—Under current law the loss of Aid to Families with Dependent Children (AFDC) eligibility often means a loss of Medicaid eligibility as well. The 1981 Reconciliation Act makes certain working families ineligible for AFDC as a result of changes in the earned income disregard and work expense deductions.

Committee amendment.—The committee amendment allows the States to continue Medicaid coverage for working families who are made ineligible for AFDC as a result of certain changes made by the 1981 Reconciliation Act.

Effective date.—Beginning with the first calendar quarter after enactment.

Estimated costs.—

Fiscal years:	Millions
1983	−$1
1984	−1
1985	−1

C. PROVISIONS RELATED TO UTILIZATION AND QUALITY CONTROL PEER REVIEW

CONTRACT FOR UTILIZATION AND QUALITY CONTROL PEER REVIEW

(Sections 141–150 of the Bill)

Present law.—Under current law, Professional Standards Review Organizations (PSROs) are charged with the ongoing review of services provided under Medicare and may be contracted with by States for review under Medicaid. PSROs, where established, determine, for purposes of reimbursement under these programs, whether services are: (1) medically necessary; (2) provided in accordance with professional standards; and (3) in the case of institutional services, rendered in the appropriate setting. The "Omnibus Budget Reconciliation Act of 1981," P.L. 97-35, required the Secretary to develop PSRO performance criteria and assess, not later than September 30, 1981, the relative performance of each PSRO. Based on this assessment, the Secretary was authorized to terminate up to 30 percent of existing PSROs. The total number of operational PSROs was reduced from 187 in May 1981 to 148 in April 1982.

Public Law 97-35 also provided for the optional use of PSROs under State Medicaid plans. States may contract with PSROs for the performance of required review activities; 75 percent Federal matching is available for this purpose.

Committee amendment.—The committee amendment repeals the existing PSRO provision and provides for the establishment of a utilization and quality control peer review program.

The committee notes that the PSRO program was established in 1972 as a result of rapidly increasing costs of Medicare and Medicaid and the failure of the existing utilization and claims review mechanisms to deal with widespread inappropriate usage of costly health care services. These problems remain today.

The committee notes that the PSRO program has had mixed results. On the positive side, peer review has afforded practicing physicians an opportunity on a voluntary and publicly accountable basis to undertake review of the medical necessity and quality of care provided. The program has demonstrated that the concept of peer review is a valid one. Where physicians are willing to work cooperatively, the program can do much to prevent unnecessary services and thereby minimize risks to patients and the waste of valuable resources that are needed elsewhere. Further the committee notes that the PSRO program has shown that these objectives can be achieved through an effective partnership between the Government and the private sector.

The PSRO program has, however, been faced with certain structural problems. Overregulation and too detailed specifications in laws have restricted innovation in new approaches to review. The private sector must be encouraged to institute approaches designed to assure quality while eliminating unnecessary services. Administrative functions of organizations engaged in review activities can and must be arranged in a more cost-effective manner.

The bill capitalizes on the positive aspects of the PSRO program and enables entities who have proven their effectiveness to enter into performance based contracts for the conduct of peer review.

The bill requires the Secretary to enter into contracts with peer review organizations for an initial period of 2 years, renewable biennially, for the purpose of promoting the effective, efficient, and economical delivery of quality health care services under Medicare. The organizations must be composed of, or have available to them a substantial number of licensed doctors of medicine or osteopathy actually practicing in the area. Priority consideration must be given to organizations that are representative of the physicians in the area—that is, to physician-sponsored organizations which have the general support of the physicians in the area. Payor organizations (i.e., insurance companies and similar entities) and provider organizations will be excluded from consideration during the first 12 months that contract applications are considered. Organizations who do not write health insurance policies, collect premiums or assume an underwriting function, would not be considered an insuring organization for purposes of this section.

The bill requires the Secretary to consolidate geographic areas previously established for PSROs. It is expected that each State would generally be designated as a geographic area. Local or regional areas could be designated only if the volume of review warrants it.

The review organizations, which can be for profit or nonprofit, may review the professional activities of physicians, other practitioners and institutional and noninstitutional providers in providing services to Medicare beneficiaries subject to the provisions of these contracts. The review will focus on (1) the necessity and reasonableness of care, (2) quality of care, and (3) the appropriateness of the setting.

The amendment provides that the determinations of the peer review organizations would ordinarily be binding for purposes of determining whether benefits should be paid. A beneficiary, practitioner, or provider who is dissatisfied with a determination made by the review organization is entitled to a reconsideration and under certain conditions to further administrative reviews and judicial review.

If an organization determines that a practitioner or provider has persisted in violating his obligation to provide services which are medically necessary, meet professionally recognized standards of care and are cost-effective, it may recommend exclusion from the program. Where the Secretary fails to act on the sanction recommendation of a review organization within 120 days, the practitioner or provider in question will be excluded from Medicare reimbursement until the Secretary determines otherwise.

The amendment modifies the waiver of liability provision of present law under which hospitals and other providers of services may receive payments for medically unnecessary care under certain circumstances. Under the bill, the review organization would have authority to limit applicability of a waiver of liability granted by an intermediary or carrier so that payment would be denied for services that are part of a pattern of inappropriate utilization. Payment would be withheld in these cases only where the provider has had an opportunity to correct the abuse but has failed to do so.

The amendment clarifies the confidential nature of data acquired by a peer review organization. An organization, in carrying out its functions under contract will not be considered a Federal agency for purposes of the Freedom of Information Act.

The committee has been impressed by the number of non-government entities wishing to contract with PSROs for the performance of review activities. The amendment facilitates the performance of private review by requiring a peer review organization to make available its facilities and resources to private payors paying for health care in its area on a contract basis. Medicare providers would continue to be required to release medical records of Medicare patients and to release the same type of information on private patients if so authorized.

As under present law, States could choose to use these organizations or any others to review care received by medicaid patients. The Federal Government will provide a 75 percent match for the cost of the review of Medicaid patients.

The new flexibility that the bill would give to review organizations and the Federal Government in negotiating contracts will place many new demands on medicare contract administrators. It is the committee's intent that the Department devote the full resources to this effort that will be needed.

Effective date.—Enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$15
1984	15
1985	20

D. PROVISIONS RELATED TO AID TO FAMILIES WITH DEPENDENT CHILDREN

(Subtitle D of Title I)

ROUNDING OF ELIGIBILITY AND BENEFIT AMOUNTS

(Section 151 of the Bill)

Present law.—There is no provision in current law relating to the rounding of benefits.

Committee amendment.—The committee amendment would require States to round both their need standard and actual monthly benefit amounts to the lower whole dollar. (A similar change is also being made in the SSI program.) This change would simplify administration of the program and would have a minimal impact on beneficiaries.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$9
1984	10
1985	10

EFFECTIVE DATE OF APPLICATION; PRORATION OF FIRST MONTH'S AFDC BENEFIT

(Section 152 of the Bill)

Present law.—Current regulations allow States to pay benefits beginning with the first day of the month in which an application is filed. At the present time 12 States have chosen to do this. States which do not begin payments with the first of the month must begin assistance no later than the date on which the welfare agency approves the application, or 30 days from the date the application is complete, whichever is earlier.

Committee amendment.—The committee amendment would require States to pay benefits beginning no earlier than the date an application is filed. Any payment for the month application would be prorated based on the date of application. (A similar change is being made in the SSI program.) An amendment to the Food Stamp Act requiring that the first month's food stamp benefit be prorated from the date of application was enacted in the 1981 Reconciliation Act.

Since AFDC benefits are paid only to needy families, the committee believes that benefits should not be provided for periods prior to the time when the family itself recognizes the need and requests assistance.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$13
1984	14
1985	14

ELIMINATE UNIFORMED SERVICE AS BASIS FOR AFDC ELIGIBILITY

(Section 153 of the Bill)

Present law.—AFDC is payable to needy families if the need arises because of active duty in uniformed service. The Administration estimates that about 10,000 families who are now receiving AFDC report that their need is caused by absence due to uniformed service. Any income which these families may actually receive from the absent parent is counted in determining the family's benefit.

Committee amendment.—The committee amendment would exclude absence based solely on active duty in a uniformed service as a basis for need. However, if the parent has left the home for other reasons, the family may still be eligible for assistance. In this case, as provided in present law, the custodial parent would have to assign to the State any rights to child support which have accrued.

The committee believes that the absence of a parent solely because of active uniformed duty should not be a basis of AFDC eligibility. The parent in the service should retain the responsibility for supporting any children. A companion provision (sec. 172) would require allotments from the pay and allowances of any member of the uniformed services (on active duty) when he fails to make child support payments.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$15
1984	17
1985	17

REFUSAL TO WORK

(Section 154 of the Bill)

Present law.—Current regulations provide sanctions for AFDC recipients who are required to register for the Work Incentive Program (WIN) if they voluntarily quit work, reduce earnings, refuse employment, or refuse assignment to a community work experience project. Sanctions may not be applied in the case of persons who are not currently required to register, including persons who are employed 30 hours or more a week, or who live in an area so remote from a WIN program that their participation is precluded.

Committee amendment.—The committee amendment would give the Secretary authority to prescribe in regulations the period for which a sanction could be imposed if an individual (who is exempt from WIN registration because he is employed 30 hours or more a week, or lives in an area so remote from a WIN project that his participation is precluded): (1) refuses a bona fide offer of employment, (2) terminates employment, or (3) reduces his hours of employment, without good cause. In AFDC-UP families, assistance would be denied to the entire family. In other families, the individual who is sanctioned would be excluded from the family grant and, if the individual is the caretaker relative, protective payments would be made on behalf of the children.

The committee believes that persons who are exempt from WIN registration because of remoteness from a WIN program or because they are already employed on a substantially full-time basis should be subject to sanction when they terminate, reduce, or refuse employment. The basis for their exemption from WIN has no relation to their employability. This amendment would close a loophole in current law by applying sanctions to all employable individuals as originally intended in the law.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$1
1984	1
1985	1

MANDATORY JOB SEARCH

(Section 155 of the Bill)

Present law.—Amendments enacted in 1980 included a provision specifically authorizing Federal matching for job search activities which are part of a State's work incentive program. Both the statute and the regulations provide sanctions if a recipient who is required to register for WIN and who has been certified as ready for employment refuses without good cause to participate in job search. In the case of the principal earner in an unemployed parent family, the sanction is denial of benefits for the entire family. In other cases, the individual who refuses is removed from the grant and the family's benefit is reduced. The sanction period is 3 months in the case of a first refusal and 6 months in the case of any subsequent refusals.

Committee amendment.—The committee amendment would require each State to include in its State plan the requirement that as a condition of eligibility, individuals required to register for employment and training (or who would be required to register except for remoteness from a WIN site) will be required to participate in a program of employment search beginning at the time of application. The individual would also be required annually to participate in a program of employment search after his application becomes effective whenever the State agency prescribes, but not more than a total of eight weeks in each year. An individual who refuses to comply with the requirement for employment search would be subject to the same penalties as an individual who refuses to comply with other work requirements.

The State would have to provide assurances to the Secretary that the employment search requirements were being complied with. There would have to be coordination between the employment search program and other programs to assure that priority is given to job placement over participation in another activity. Costs of operating the job search program would be matched by the Federal Government as an administrative cost at the 50 percent matching rate.

The committee believes that when employable individuals apply for AFDC, an attempt should be made to place them in employment while their application for assistance is being processed. There has now been considerable experience in conducting job search programs, both in the Work Incentive (WIN) program and under various demonstration programs. The evidence accumulated as a result of this experience has convinced the committee that significant numbers of AFDC applicants and recipients can be assisted in finding jobs through job search programs. For example, results from a WIN demonstration using the job club method of finding jobs for AFDC recipients showed that this method was effective for all types of recipients, even in areas of high unemployment. This demonstration, conducted in Harlem, New Brunswick, Tacoma, Wichita and Milwaukee, resulted in the placement of 62 percent of the job club participants.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$20
1984	50
1985	50

INCLUSION AND EXCLUSION OF SPECIFIED INDIVIDUALS' NEEDS AND INCOME

(Section 156 of the Bill)

Present law.—The AFDC statute does not provide a definition of what constitutes an AFDC family. The law and regulations establish certain limitations on who may be included in the family unit, and whose income and resources may be considered in determining eligibility.

Committee amendment.—The committee amendment would define in the statute those individuals whose needs must and must not be included in determining a family's AFDC benefit, and would establish rules for counting as available to the AFDC unit the income of certain individuals who are not in the family unit. Following are the basic changes from present law and regulations which would be made by the new statutory language:

Eligibility of a parent.—Current law permits States to include the needs of a parent or caretaker relative in determining the AFDC benefit so long as there is an eligible child. The child is permitted to retain eligibility to age 18 (or 19 if the child is in school and is expected to complete his course of study before reaching his 19th birthday).

The committee amendment would require States to include the needs of a parent, but only until the youngest child reaches age 16. The income and resources of the ineligible parent would be counted in determining the benefit for the child. The State would continue to include the need of a parent of an older eligible child if the parent is unemployable.

The committee believes that by the time the youngest child reaches age 16 the parent is sufficiently free from child care responsibilities to be able to undertake employment. The committee notes that about 66 percent of all mothers with children of school age are in the labor force, and that the participation of mothers of all children, and in particular of school age children, has increased rapidly in recent years. This change in AFDC eligibility rules reflects the growing participation of mothers in employment throughout the society.

Estimated savings.—

Fiscal years:	*Millions*
1983	$47
1984	48
1985	48

Eligibility of a child.—Current law permits families to exclude a child from the assistance unit if that child has income which would reduce the amount of the family's benefit.

The committee amendment would require States to include all children in the family unit (except disabled children receiving SSI benefits, and certain stepbrothers and stepsisters). This change will end the present practice whereby families exclude members with income, such as social security or child support payments, in order to maximize family benefits, and will ensure that the income of family members who live together and share expenses is recognized and counted as available to the family as a whole.

In addition, under current law the income of parents of a minor child who is herself the parent of a child is not counted in determining the eligibility and benefit of the grandchild.

The committee amendment would require States to count the income of the grandparents who are living in the same household as available to the grandchild, after setting aside certain amounts to cover their own needs. The AFDC payment would be made to the grandparent. The committee believes that the income of the parents of a minor child who becomes a parent should be available to the grandchild. By making the check payable to the parents of a teenage parent, the bill would give those parents opportunity to oversee the welfare of their child and grandchild.

Estimated savings.—

Fiscal years:	Millions
1983	$63
1984	64
1985	64

Counting of income of unrelated individuals.—Currently, the income of an unrelated person in an AFDC household may not be presumed to be available to the household, and the welfare agency may count only actual contributions which it knows have been made by the individual to the AFDC family.

The committee amendment would require States to count the income of any person living with the child and with the child's natural or adoptive parent if that person is not related to the child or parent or to any other individual living in the household. The income of this unrelated individual would be considered available to the AFDC family, after setting aside certain amounts to cover the needs of the unrelated person and any dependents.

Estimated savings.—

Fiscal years:	Millions
1983	$69
1984	70
1985	70

Effective date.—All three of the above provisions would be effective on enactment.

REPEAL OF EMERGENCY ASSISTANCE PROGRAM

(Section 157 of the Bill)

Present law.—The emergency assistance program provides 50 percent matching for emergency assistance (in the form of cash, medical care, or services) to families with children under a State's AFDC plan (including both AFDC and non-AFDC families). Assistance may be provided for no more than 30 days in any 12 month period. The program was enacted in 1967, and is optional with the States. In December 1980, 27 jurisdictions had established emergency assistance programs:

- Arkansas
- Connecticut
- Delaware
- District of Columbia
- Illinois
- Kansas
- Kentucky
- Maryland
- Massachusetts
- Michigan
- Minnesota
- Missouri
- Montana
- Nebraska
- New Jersey
- New York
- Ohio
- Oklahoma
- Oregon
- Pennsylvania
- Puerto Rico
- Virgin Islands
- Virginia
- Washington
- West Virginia
- Wisconsin
- Wyoming

Committee amendment.—The committee amendment would repeal the emergency assistance program. Legislation has been proposed to make emergency assistance an allowable use of funds under the Low-Income Home Energy Assistance Block Grant.

Effective date.—October 1, 1982.
Estimated savings.—

Fiscal years:	Millions
1983	$60
1984	60
1985	60

PRORATION OF STANDARD AMOUNT FOR SHELTER AND UTILITIES

(Section 158 of the Bill)

Present law.—AFDC regulations generally prohibit the States from prorating or otherwise reducing the AFDC benefit solely because of the presence in the household of an individual who is not legally responsible to support the family. This general prohibition was modified in Public Law 96-272 to allow States to prorate the shelter and utilities portion of the AFDC benefit in the case of "child only" family units, i.e., when the parent is not eligible for assistance.

Committee amendment.—The committee amendment would allow States to prorate the portion of the AFDC grant for shelter and utilities whenever the assistance unit shares the household with other individuals. The committee amendment gives the States flexibility in determining how the proration provision would be applied. It requires that proration be accomplished "on a reasonable basis," and in a manner and under circumstances prescribed by the State. States would not be allowed to prorate for a recipient of Supplemental Security Income benefits to whom the one-third reduction applies. (The one-third reduction in the SSI benefit occurs when individuals are determined to be living in the household of another and receiving in-kind income in the form of food and shelter.)

The Administration had proposed that the proration provision be made mandatory on the States. The Administration proposal also prescribed how the proration was to be applied in individual cases. The committee modified this proposal, agreeing instead that whether a State prorates benefits and the method of proration should be matters decided by each State. The States themselves are better able to make these decisions, taking into consideration their own AFDC programs and caseloads. Each State would have the flexibility to decide the method of proration based on its own policy and administrative considerations. For example, a State may wish to apply proration under narrow circumstances and not prorate where the non-AFDC household members receive SSI, have little or no income (for instance, lower than the State standard of need), or are unrelated. On the other hand, a State may prorate in all situations where the AFDC assistance unit shares shelter and utilities with other individuals. The committee believes that the adoption of this optional provision recognizes the fact that where individuals share a household, the shelter and utility expenses for each individual are less.

Effective date.—On enactment.
Estimated savings.—

Fiscal years:	Millions
1983	$43
1984	44
1985	45

REDUCTION OF FEDERAL MATCH FOR PAYMENT ERRORS

(Section 159 of the Bill)

Present law.—In the four major welfare programs, AFDC, SSI, medicaid, and the food stamp program, the Federal Government and the States have established on-going "quality control" systems. These systems attempt to: (1) measure the extent and dollar value of "errors" in administration; (2) identify the types and causes of error; and (3) specify and monitor corrective actions taken to eliminate or reduce errors.

In the AFDC, medicaid, and food stamp programs, States may be "sanctioned" by being required to pay the Federal Government the Federal cost of improperly issued benefits, as shown by quality control surveys, if they do not keep their error rates below a national average or show a reduction in their error rates that meets a regularly adjusted "target improvement rate". However, waivers of these sanctions are allowed and have, thus far, been regularly granted. The fiscal sanction that may be imposed is the amount of Federal funds misspent above what the State's error rate would have been if it had met its target improvement rate. In the SSI system, the Federal Government is to reimburse States for their share of federally administered SSI funds misspent above a 4 percent "tolerance level".

The regulations prescribing the AFDC sanction rules were issued pursuant to a provision in the fiscal year 1980 appropriation bill (sec. 201 of H.R. 4389), the so-called "Michel amendment", which directed the Secretary to issue regulations requiring States to reduce their AFDC payment error rate to 4 percent by September 30, 1982. Although the bill was not enacted, the Congress adopted a continuing resolution (Public Law 96-123) to appropriate 1980 funds "to the extent" and "in the manner" of H.R. 4389, as adopted by the House on August 2, 1979. This legislation was interpreted by the Department as requiring the implementation of section 201.

Under these regulations, States are required to achieve one-third progress toward the 4-percent payment error rate (measured from their error rate for the base period April-September 1978) by September 30, 1980, and two-thirds progress by September 30, 1981. The 4-percent goal is the standard for all assessment periods after September 30, 1982.

The national average payment error rate for recent measurement periods has been: April-September 1979, 9.5 percent; October 1979-March 1980, 8.3 percent; and April-September 1980, 7.3 percent. For that most recent period, only four States had achieved the 4-percent goal: Minnesota, Iowa, Nevada, and Oregon.

Committee amendment.—For the AFDC program, the committee amendment will continue the 4-percent error rate tolerance level for fiscal year 1983 and reduce that tolerance level to 3 percent effective for fiscal year 1984 and thereafter. Until April 1, 1983, any sanctions would continue to be applied under the existing authority of the Michel amendment. Starting on that date a new sanction authority would be established. Under this new authority, Federal payments to the States will be reduced each quarter on a current basis to reflect the Secretary's estimates as to the error rate prevailing in the State program during that quarter. If the Secretary's estimates prove to be incorrect when actual data become available, appropriate adjustments will be made in subsequent grants. The committee amendment continues the present authority of the Secretary to waive the sanctions in limited cases where he finds that States have failed to meet the target error rates despite a good faith effort to do so.

The committee is aware that many questions remain to be resolved relative to the matter of sanctions for excessive rates of error. For example, under the regulations in effect prior to the Michel amendment, no sanctions have in fact been imposed. However, the Administration projections of program costs under present law appear to be based on an assumption that no waivers would be granted. The committee believes that the question cannot be predetermined either way but must be based on a case-by-case examination by the Secretary of the situation in a State, taking into account relevant circumstances including the question of whether the State has shown a sustained record of improvement over a period of years. The committee intends that the provision be administered in a way which will achieve its objectives on a reasonable basis. This requires recognition that the purpose of the provision is to provide a strong incentive for improved program accuracy and to avoid Federal participation in erroneous payments. It also requires recognition of the limitations on what it is possible to accomplish even with good faith efforts aimed at full compliance.

Because of these questions the committee has deferred the effective date of the new procedure until April 1, 1983. This should allow time for the Administration to make any necessary revisions to its regulations and to consider State concerns relating to the accuracy and timeliness of the present quality review system. The committee itself intends to review the issues raised with respect to this provision during that period, and may recommend further legislation, if such action is determined to be necessary to assure that the provision operates in such a way as to achieve its purposes in an equitable and accurate manner.

Effective date.—October 1, 1982.

Estimated savings.—

Fiscal years:	*Millions*
1983	$85
1984	129
1985	41

HOUSEHOLDS HEADED BY MINOR PARENTS

(Section 160 of the Bill)

Present law.—Minor parents who have children may establish their own AFDC households, so long as they meet eligibility criteria. No effort is made to keep a teenage mother in the home of her own parent or guardian.

Committee amendment.—The committee amendment would require that in order to qualify for AFDC benefits, a minor parent and her child would have to reside in the home of the minor parent's own parent or guardian. This requirement would not apply where: the minor parent was married at the time of (or at any time prior to) application for benefits, the minor parent has no parent or legal guardian who is living and whose whereabouts are known, the State agency determines that the health and safety of the minor parent or child would be seriously jeopardized if they lived in the same residence with the parent or legal guardian, or the minor parent lived apart from her parent or legal guardian for a period of at least one year prior to the birth of the child.

This amendment is an extension of Section 156 of the committee bill, which requires the counting of the income of parents of minors with children and requires payment of the benefit check to the parent of the minor parent if the minor parent is living with the parent.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$25
1984	27
1985	29

EXCLUSION FROM INCOME OF CERTAIN STATE PAYMENTS

(Section 161 of the Bill)

Present law.—A provision in the 1981 Reconciliation Act required States to determine AFDC benefits on the basis of the family's income in the preceding month. Under certain circumstances, payment may be determined on the basis of income in the second preceding month. This may be necessary, for example, when the payment date is in the first week of the month and the State needs time to process the monthly report of income which must be submitted by the recipient.

A State which has such a lag between the month for which income is counted and the payment date may wish to supplement the AFDC payment with a wholly State-financed payment. It may choose to do this, for example, for families which lose employment and suffer an immediate loss in income. Under present law, however, if the State decides to assist a family during a payment adjustment lag, any supplement which it pays to the family is counted as income for purposes of determining the AFDC benefit. This has the effect of reducing the next AFDC benefit check, and the State may find that it must supplement the AFDC benefit again in order to meet the family's needs. The fact that the State supplementary payment must be counted as income for AFDC establishes a cycle which may force the State to supplement the AFDC benefit on a continuing basis.

Committee amendment.—The committee amendment would allow States to exclude from calculations of AFDC benefit amounts any payments made solely from State funds that are designed to compensate for lost income in the period before the new benefit amount can be calculated and paid.

Effective date.—On enactment.
Estimated savings.—

Fiscal years:	Millions
1983	$0
1984	0
1985	0

EXTENSION OF TIME FOR STATES TO ESTABLISH A WORK INCENTIVE DEMONSTRATION PROGRAM

(Section 162 of the Bill)

Present law.—The 1981 Reconciliation Act included a provision authorizing States to operate 3-year demonstration programs as alternatives to the current WIN program. The demonstration is aimed at testing single-agency administration and must be operated under the direction of the State welfare agency. The legislation includes broad waiver authority designed to encourage States to develop innovative programs which best meet their own State needs.

The legislation required States to submit an application to the Secretary of Health and Human Services specifying intent to operate a WIN demonstration program. This application had to be submitted within 60 days after enactment. A total of 26 States met this application deadline, indicating their intent to begin a WIN demonstration. Since that time, however, a number of these States have not followed through on their applications because of the severe cut in WIN funding for fiscal year 1982, and the proposal by the Administration to repeal the program beginning in 1983. The committee has not agreed with the Administration that WIN should be repealed, and notes that the Congress in its action on recent urgent supplemental bills has registered its desire to increase the funding which is available for 1982.

Committee amendment.—The committee amendment would allow States a period of two additional years in which to exercise their option to operate a WIN demonstration program. This would give the States until June 30, 1984 to make this decision. The committee believes that the new activities which States are planning and have recently undertaken (with respect to employment and training programs for WIN registrants) justify this amendment to further encourage the development of new programs. This extension of the period for application will give States ample time to consider their needs and the methods which they believe will be most useful in serving their AFDC applicants and recipients.

Effective date.—On enactment.
Estimated savings.—

Fiscal years:	Millions
1983	$0
1984	0
1985	0

E. PROVISIONS RELATED TO CHILD SUPPORT ENFORCEMENT

(Subtitle F of Title I)

FEE FOR SERVICES TO NON-AFDC FAMILIES

(Section 171 of the Bill)

Present law.—States are required to provide child support collection services to non-AFDC families requesting assistance. Prior to the Omnibus Budget Reconciliation Act of 1981 (P.L. 97-35), States had the option of charging non-AFDC families a reasonable fee and then retaining a portion of any child support collection to pay for administrative expenses not covered by the fee. Under the Reconciliation Act provisions, States retain the option of charging non-AFDC recipients a reasonable application fee, but are required to charge a fee equal to 10 percent of the support collected. The 10 percent fee must be charged against the absent parent and added to the amount to be collected.

States have reported that because of legislative barriers and administrative difficulties, they have generally been unable to implement the requirement that the collection be charged only against the absent parent. The result is that they are unable to recover costs by using the 10 percent fee provision.

Committee amendment.—The committee amendment would repeal the provisions enacted in P.L. 97-35 which would require States, in cases involving non-AFDC families, to charge any absent parent who is obligated to pay child support through the State Child Support Enforcement Agency a fee equal to 10 percent of the child support payment. The amendment would restore the law in effect prior to P.L. 97-35 which allows States to charge a reasonable fee for a non-AFDC collection and retain from the amount collected an amount equal to administrative costs not covered by the fee. The amendment would also retain, as a State option, the authority to collect from the parent who owes child or spousal support an amount to cover administrative costs, in addition to the child support payment.

The amendment would provide that if a State elects to deduct such costs from the amount of any recovery made, the State shall have in effect a procedure under which the court or other entity which determines the amount of the support obligation will be notified of the amount by which any support collection will be reduced to reimburse the costs of collection. This would allow the court, if it finds such action appropriate, to increase the support order so that the income provided to the family will not be reduced.

Effective date.—August 13, 1981.

Estimated savings.—

Fiscal years:	Millions
1983	$12
1984	16
1985	11

ALLOTMENTS FROM PAY FOR CHILD AND SPOUSAL SUPPORT OWED BY MEMBERS OF THE UNIFORMED SERVICES ON ACTIVE DUTY

(Section 172 of the Bill)

Present law.—Present law does not provide for allotments from the pay and allowances of members of the U.S. Armed Forces.

Committee amendment.—The committee amendment would add a new section to title IV–D of the Social Security Act to require allotments from the pay and allowances of any member of the uniformed service (on active duty) when he fails to make child (or child and spousal) support payments. The requirement would arise when the member failed to make support payments in an amount at least equivalent to the value of two months' worth of support. Provisions of the Consumer Credit Protection Act would apply so that the percentage of the member's pay which could be garnished would be limited. The amount of the allotment will be that of the support payment, as established under a legally enforceable administrative or judicial order.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$7
1984	9
1985	10

REIMBURSEMENT OF STATE AGENCY IN INITIAL MONTH OF INELIGIBILITY FOR AFDC

(Section 173 of the Bill)

Present law.—Amounts of support collected which are sufficient to make the family ineligible for AFDC must be paid to the family beginning with the first month of ineligibility.

Committee amendment.—The committee amendment would provide that amounts collected which are sufficient to make the family ineligible would be paid to the family in months after the first month of ineligibility. This would allow the State to reimburse itself for AFDC that would have already been paid for that month before the support was collected and known to make the family ineligible. Thus, the family would not receive double payment for the same month, both in the form of AFDC and through receipt of the support collection.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$3
1984	4
1985	4

F. PROVISIONS RELATED TO SUPPLEMENTAL SECURITY INCOME (SSI)

(SUBTITLE F OF TITLE I)

PRORATE FIRST MONTH'S BENEFIT BASED UPON DATE OF APPLICATION

(Section 181 of the Bill)

Present law.—The payment of SSI benefits begins with the first day of the month in which the recipient applies and meets the eligibility requirements.

Committee amendment.—The committee amendment would prorate the first month's SSI benefit from the date of application or the date of eligibility, whichever is later. A similar change is also being made in AFDC. (A provision requiring prorating the first month's food stamp benefits from the date of application was enacted in the 1981 Reconciliation Act.) This amendment would also apply to months in which the individual reapplies after a period of ineligibility.

Since SSI is available only to the needy, the committee believes that benefits should not be provided for periods prior to the time the individual recognizes his need and requests assistance.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$26
1984	28
1985	32

ROUND SSI ELIGIBILITY AND BENEFIT AMOUNTS

(Section 182 of the Bill)

Present law.—SSI monthly benefit amounts and income eligibility amounts (which are adjusted annually to reflect changes in the cost-of-living) are rounded to the next higher ten cents.

Committee amendment.—The committee amendment would round SSI monthly benefit and income eligibility amounts to the next lower dollar. Rounding would take place after the cost of living adjustment had been made. Cost-of-living adjustments in subsequent years would be based on the *unrounded* benefit and income eligibility amounts so that the provision would have no cumulative effect from year to year. This amendment would reduce Federal outlays while having only a minimal impact on future benefits.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	Millions
1983	$20
1984	25
1985	30

COORDINATION OF SSI AND OASDI COST-OF-LIVING ADJUSTMENTS

(Section 183 of the Bill)

Present law.—A provision of the Omnibus Budget Reconciliation Act of 1981 requires that SSI benefits be determined on the basis of a monthly retrospective accounting system which replaces the quarterly prospective system existing in the past. Rather than basing SSI benefits on the applicant's or recipient's income and resources in the current calendar quarter, benefits are based on income and resources in a prior month.

Because of a defect in drafting this legislation, the annual cost-of-living increases in SSI and OASDI benefits were not coordinated. As a result, for people who receive SSI and OASDI, the new, higher OASDI benefit paid each July will not immediately be reflected in the SSI benefit. One or two months later, the SSI benefit will fall when the new, higher income is taken into account.

Committee amendment.—The committee amendment would coordinate the SSI and social security (OASDI) benefit increases so that at the time the cost-of-living adjustment is made, the recipient's SSI benefit is based on his or her social security payment in the same month. Also, whenever the Secretary judges there to be reliable information on the recipient's income or resources in a given month, the SSI benefit in that month would be based on that information. The Secretary would be required to prescribe by regulation the circumstances in which such information could be used to determine the monthly SSI benefit.

This amendment would prevent SSI recipients from experiencing each year an unintended increase in total income above the cost-of-living adjustment followed two months later by an unexpected reduction in their benefits.

Effective date.—The cost-of-living coordination would be effective for benefits payable for months beginning 60 days after enactment. The broader authority would be effective on enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$45
1984	41
1985	43

PHASE OUT "HOLD HARMLESS" PROTECTION

(Section 184 of the Bill)

Present law.—SSI provides for a basic Federal minimum payment for all recipients. States are allowed to supplement the Federal payment. The original act of 1972 included "hold harmless" protection for the States which allowed them to supplement the Federal payment to assure that recipients would receive cash benefits equal to their January 1972 benefit levels, with no cost to the

State beyond what it spent for benefits on behalf of aged, blind and disabled persons in 1972.

Because of Federal benefit increases since that time, all except two States, Hawaii and Wisconsin, have lost their "hold harmless" status. These two States still receive a Federal contribution to their State supplements because of a special provision added to the law in 1976. Under this provision, their "hold harmless" payments are no longer reduced by Federal benefit increases.

The 1982 Continuing Resolution provided for a reduction in "hold harmless" payments for Wisconsin and Hawaii.

Committee amendment.—The committee amendment would continue phasing out "hold harmless" payments requiring hold harmless States to pay an increasing share of the cost of their supplementary benefits. These States would be required to pay 60 percent of the costs that would otherwise be paid by the Federal government in 1983, 80 percent in 1984, and 100 percent in 1985 and future years.

The committee believes that Federal hold harmless payments, now made to just two States, are no longer necessary for meeting the objectives of the initial SSI legislation of 1972. The original legislation, which required some State supplementation, was intended to assure that people receiving old-age assistance, aid to the blind, or aid to the permanently and totally disabled would not suffer a loss of income with the inception of the Federal SSI program, while protecting States from an increased fiscal liability due to caseload growth.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$30
1984	37
1985	45

RECOVERY OF SSI OVERPAYMENTS

(Section 185 of the Bill)

Present law.—The Secretary is required to recover SSI overpayments by adjusting future payments, or by recovery from the recipient. Recovery of overpayments is to be made with a view to avoiding penalizing the individual who is without fault. Recovery of overpayments is not required, for example, if the individual is without fault and if recovery would defeat the purpose of the program, or be against equity or good conscience, or the amount to be recovered is so small as to impede efficient or effective administration.

Committee amendment.—The committee amendment would, under these same conditions, allow recovery of SSI overpayments from benefits payable under other programs administered by the Social Security Administration (Black Lung and OASDI benefits).

Presently, 40–50 percent of SSI overpayments are not recovered mainly because the overpaid individuals are no longer eligible for SSI. Yet, about half of these overpaid SSI recipients continue to receive social security benefits from which the overpayments could be recovered.

The committee believes that in cases where individuals receive income support from SSI as well as from other programs administered by SSA, these other sources of income should be taken into account in overpayment recovery situations.

The committee understands that departmental regulations: (1) limit the reduction of SSI payments (in any one month) for the collection of overpayments so as to avoid leaving individuals totally without resources, and (2) provide that assistance payments will generally not be increased simply to replace income losses occasioned by reductions in benefits from other programs to collect overpayments. The committee expects that this provision will be administered in a similar manner. On the one hand, reductions should be made with due regard for the ongoing needs of the individual. On the other hand, it is not intended that SSI payments be increased to replace the social security or other benefits being withheld.

Effective date.—On enactment.

Estimated savings.—

Fiscal years:	*Millions*
1983	$16
1984	17
1985	18

G. Provisions Related to Unemployment Compensation

(Subtitle G of Title I)

ROUND UNEMPLOYMENT BENEFITS TO NEXT LOWEST DOLLAR

(Section 191 of the Bill)

Present law.—Under present law the States may determine rounding procedures to apply in the calculation of an individual's weekly unemployment benefit.

Committee amendment.—The committee agreed to an amendment under which the Federal 50 percent matching share of extended unemployment benefits would not be available on that part of extended unemployment benefit payments which result from a failure on the part of the State to have a benefit structure in which benefits are rounded down to the next lower dollar.

This amendment would reduce Federal outlays while having only a minimal impact on future unemployment benefits.

Effective date.—This provision would be effective for benefits payable on or after October 1, 1983. States in which there is no legislative session prior to that date would, however, be given additional time before the provision would become effective.

Estimated savings.—

Fiscal years:	*Millions*
1983	$0
1984	10
1985	19

IV. COSTS OF CARRYING OUT THE SPENDING REDUCTION PROVISION OF THE BILL AND VOTE OF THE COMMITTEE

BUDGET EFFECTS

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., July 12, 1982.

Hon. ROBERT DOLE,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has prepared the attached cost estimate for certain provisions of H.R. 4961, a bill that would raise revenues and change Medicare, Medicaid and income security programs to reduce budget outlays as directed by the First Concurrent Resolution on the Budget for Fiscal Year 1983.

This estimate includes the revenue and spending effects of the proposed program changes to reduce budget outlays and the provisions relating to the Airport and Airway System Development Act. The budgetary effects of the revenue raising provisions will be addressed in a subsequent estimate. That estimate will include revenue and budget authority estimates of provisions such as the proposed increase in the federal unemployment tax and the proposed extension of Social Security hospital insurance taxes to federal employees.

Should the Committee so desire, we would be pleased to provide further details on the attached cost estimate.

Sincerely,

ALICE M. RAVLIN,
Director.

CONGRESSIONAL BUDGET OFFICE—COST ESTIMATE

1. Bill number: H.R. 4961 (excluding revenue raising provisions).
2. Bill title: Not available.
3. Bill status: As ordered reported by the Senate Committee on Finance on July 2, 1982.
4. Bill purpose. To make changes in the Medicare, Medicaid and income security programs to reduce budget outlays as directed by the First Concurrent Resolution on the Budget for Fiscal Year 1983. This bill also provides new direct spending authority from the Airport and Airway Trust Fund for grants-in-aid to airports and authorizes appropriations from the Trust Fund for certain other activities of the Federal Aviation Administration.

96-028 O - 82 - 5

5. Cost estimate:

TABLE 1.—SUMMARY OF BUDGETARY EFFECTS OF H.R. 4961

[By fiscal year, in millions of dollars]

		1982	1983	1984	1985	1986	1987
a. Revenue changes		0	−80	−125	−140	−155	−180
b. Spending reductions (direct spending)	BA	−142	−1, 432	−1, 973	−2, 427	−3, 112	−3, 848
	O	0	−4, 163	−5, 897	−7, 131	−9, 189	−11, 351
c. Spending increases (direct spending)	BA	460	752	1, 002	1, 336	2, 133	2, 646
	O	0	185	468	611	772	1, 054
d. Spending increases (authorizations)	BA	26	2, 635	3, 233	3, 283	3, 230	3, 058
	O	18	1, 825	2, 190	2, 696	3, 097	3, 251
Total	BA	344	1, 955	2, 262	2, 192	2, 251	1, 856
	O	18	−2, 153	−3, 239	−3, 824	−5, 320	−7, 046

TABLE 2.—DETAILS OF BUDGETARY EFFECTS OF H.R. 4961

[By fiscal year, in millions of dollars]

		1982	1983	1984	1985	1986	1987
A. REVENUE CHANGES							
Modify coverage of working aged (medicare)		0	−80	−125	−140	−155	−180
B. SPENDING REDUCTIONS (DIRECT SPENDING)							
Medicaid (function 550):							
Allow States to require nominal copayments on certain services.	BA	−10	−32	−47	−53	−59	−65
	O	0	−42	−47	−53	−59	−65
Eliminate matching for medicare pt. B buy-in.	BA	−49	−154	−216	−230	−242	−254
	O	0	−203	−216	−230	−242	−254
Allow States to apply liens	BA	−44	−139	−200	−221	−241	−263
	O	0	−183	−200	−221	−241	−263
Reduce error rate tolerances	BA	−7	−23	−65	−72	−80	−88
	O	0	−30	−65	−72	−80	−88
Impact of proposed medicaid legislation on current law penalties.	BA	0	0	100	100	0	0
	O	0	0	100	100	0	0
Medicaid impact of AFDC proposals	BA	−25	−75	−130	−170	−190	−210
	O	0	−100	−130	−170	−190	−210
Medicaid impact of limiting reimbursement to hospitals in HI.	BA	−7	−23	−80	−140	−150	−200
	O	0	−30	−80	−140	−150	−200
Total, medicaid	BA	−142	−446	−638	−786	−962	−1, 080
	O	0	−588	−638	−786	−962	−1, 080
Medicare (function 550):							
Delay initial eligibility date:							
Medicare—HI	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−120	−155	−185	−210	−240
Medicare—SMI	BA	0	−19	−21	−25	−28	−30
	O	0	−50	−75	−85	−100	−110
Modify coverage of working aged:							
Medicare—HI	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−250	−390	−430	−500	−570
Medicare—SMI	BA	0	−25	−30	−33	−38	−43
	O	0	−70	−100	−120	−130	−150
Require home health copayments: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−35	−65	−75	−80	−85
PSRO: Medicare—HI	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−15	−15	−20	−20	−25
Reduce reimbursement for radiology and pathology services: Medicare—SMI.	BA	0	−53	−63	−70	−80	−91
	O	0	−160	−210	−250	−280	−320
Index part B deductible: Medicare—SMI.	BA	0	−39	−64	−90	−121	−163
	O	0	−65	−155	−255	−360	−485
Limitation on economic index: Medicare—SMI.	BA	0	−98	−115	−133	−153	−176
	O	0	−230	−390	−460	−530	−610
Repeal the routine nursing salary differential: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−95	−110	−125	−145	−165
Impose salary equivalency test for hospital based physicians: Medicare—SMI.	BA	0	−18	−21	−24	−27	−30
	O	0	−63	−73	−84	−96	−108
Hold pt. B premiums constant: SMI premiums—Offsetting receipts.	BA	0	−36	−204	−499	−900	−1, 400
	O	0	−36	−204	−499	−900	−1. 400
Limit reimbursement to hospitals: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−610	−1, 720	−3, 120	−3, 560	−4, 590

TABLE 2.—DETAILS OF BUDGETARY EFFECTS OF H.R. 4961—Continued

[By fiscal year, in millions of dollars]

		1982	1983	1984	1985	1986	1987
Require medicare regulation:							
Eliminate private room subsidy: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−54	−75	−80	−85	−90
Establish single reimbursement limit for SNF and HHA services: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−18	−46	−46	−52	−58
Eliminate duplicate payments of OP services: Medicare—SMI.	BA	0	−56	−68	−81	−95	−111
	O	0	−160	−225	−270	−325	−380
Increase funding for cost report audits: Medicare—HI.	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−130	−300	−300	0	0
Temporarily delay PIP: Medicare—HI	BA	0	(1)	(1)	(1)	(1)	(1)
	O	0	−750	−100	870	0	0
Modify reimbursement for assistants at surgery: Medicare—SMI.	BA	0	−33	−38	−44	−49	−54
	O	0	−55	−130	−150	−175	−195
Medicare payments to HMO's: Medicare.	BA	0	0	0	0	0	0
	O	0	0	0	0	0	0
Ineffective drug provision: Medicare	BA	0	0	0	0	0	0
	O	0	0	0	0	0	0
Total, medicare	BA	0	−377	−624	−999	−1,491	−2,098
	O	0	−2,966	−4,538	−5,684	−7,548	−9,581
Aid to families with dependent children (AFDC) (function 600):							
Round benefits	BA	0	−9	−10	−10	−10	−10
	O	0	−9	−10	−10	−10	−10
Prorate first month's benefit	BA	0	−13	−14	−14	−14	−14
	O	0	−13	−14	−14	−14	−14
Eliminate military service as basis for eligibility.	BA	0	−15	−17	−17	−17	−18
	O	0	−15	−17	−17	−17	−18
Sanction for refusal to work	BA	0	−1	−1	−1	−1	−1
	O	0	−1	−1	−1	−1	−1
Mandate job search	BA	0	−20	−50	−50	−50	−50
	O	0	−20	−50	−50	−50	−50
Eliminate parents' benefit when youngest child reaches age 16	BA	0	−47	−48	−48	−49	−50
	O	0	−47	−48	−48	−49	−50
Include all minor children in AFDC unit	BA	0	−63	−64	−64	−66	−67
	O	0	−63	−64	−64	−66	−67
Count income of unrelated adults	BA	0	−69	−70	−70	−72	−73
	O	0	−69	−70	−70	−72	−73
Repeal emergency assistance	BA	0	−60	−60	−60	−61	−61
	O	0	−60	−60	−60	−61	−61
Permit States to prorate shelter	BA	0	−43	−44	−45	−46	−47
	O	0	−43	−44	−45	−46	−47
Reduce error rate tolerances	BA	0	−85	−129	−41	−41	−41
	O	0	−85	−129	−41	−41	−41
Require minor parents to reside with parents or guardians.	BA	0	−25	−27	−29	−32	−35
	O	0	−25	−27	−29	−32	−35
Exclude certain State payments from income.	BA	0	0	0	0	0	0
	O	0	0	0	0	0	0
Extend time for establishment of WIN demonstrations.	BA	0	0	0	0	0	0
	O	0	0	0	0	0	0
Total, AFDC	BA	0	−450	−534	−449	−459	−467
	O	0	−450	−534	−449	−459	−467
Supplemental security income (SSI) (function 600):							
Prorate first month's benefit	BA	0	−26	−28	−32	−36	−37
	O	0	26	−28	−32	−36	−37
Round benefits	BA	0	−20	−25	−30	−30	−30
	O	0	−20	−25	−30	−30	−30
Coordinate cost-of-living adjustments	BA	0	−45	−41	−43	−42	−42
	O	0	−45	−41	−43	−42	−42
Phase out "hold harmless"	BA	0	−30	−37	−45	−45	−45
	O	0	−30	−37	−45	−45	−45
Recover overpayments	BA	0	−16	−17	−18	−19	−20
	O	0	−16	−17	−18	−19	−20
Total, SSI	BA	0	−137	−148	−168	−172	−174
	O	0	−137	−148	−168	−172	−174
Child support enforcement (function 600):							
Alter fee for non-AFDC families	BA	0	−12	−16	−11	−13	−14
	O	0	−12	−16	−11	−13	−14
Assign wages for members of the armed forces.	BA	0	−7	−9	−10	−10	−10
	O	0	−7	−9	−10	−10	−10
Reimburse state agencies for ineligible AFDC families.	BA	0	−3	−4	−4	−5	−5
	O	0	−3	−4	−4	−5	−5
Total, child support	BA	0	−22	−29	−25	−28	−29
	O	0	−22	−29	−25	−28	−29

TABLE 2.—DETAILS OF BUDGETARY EFFECTS OF H.R. 4961—Continued

[By fiscal year, in millions of dollars]

		1982	1983	1984	1985	1966	1987
Unemployment insurance (function 600)	BA	0	0	0	0	0	0
	O	0	0	−10	−19	−20	−20
Total for provisions resulting in spending decreases.	BA	−142	−1,432	−1,973	−2,427	−3,112	−3,848
	O	0	−4,163	−5,897	−7,131	−9,180	−11,351
C. SPENDING INCREASES (DIRECT SPENDING)							
Airport and Airway System Development Act (function 400): Grants-in-aid to airports.	BA	450	600	600	600	1,049	1,207
	O	0	120	390	510	660	924
Medicaid (function 550):							
Allow states to continue medicaid eligibility for certain individuals.	BA	0	1	1	1	1	2
	O	0	1	1	1	1	2
Delay initial eligibility date in medicare	BA	5	17	28	33	38	43
	O	0	22	28	33	38	43
Reduce reimbursement for radiology and pathology services in medicare.	BA	4	11	15	20	20	25
	O	0	15	15	20	20	25
Index pt. B deductible in medicare	BA	1	4	10	20	25	30
	O	0	5	10	20	25	30
Total, medicaid	BA	10	33	54	74	84	100
	O	0	43	54	74	84	100
Medicare (function 550):							
SMI premiums—Offsetting receipts	BA	0	22	24	27	28	30
	O	0	22	24	27	28	30
Judicial review	BA	0	(2)	(2)	(2)	(2)	(2)
Increase in HI budget authority resulting from outlay savings:	O	0	(2)	(2)	(2)	(2)	(2)
Delay initial eligibility date	BA	0	5	18	34	49	62
Modify coverage of working aged	BA	0	11	40	80	114	146
Require home health copayments	BA	0	2	6	13	18	23
PSRO	BA	0	1	2	4	5	6
Repeal the routine nursing salary differential	BA	0	5	15	25	35	45
Limit reimbursement to hospitals	BA	0	30	135	370	640	920
Eliminate private room subsidy	BA	0	2	8	16	22	26
Establish single reimbursement limit for SNF and HHA services	BA	0	1	4	8	12	15
Increase funding for cost report audits	BA	0	6	25	54	62	53
Temporarily delay PIP	BA	0	34	71	31	15	13
Total HI budget authority	BA	0	97	324	635	972	1,309
Total, medicare	BA	0	119	348	662	1,000	1,339
	O	0	22	24	27	28	30
Total for provisions resulting in spending increases (direct spending).	BA	460	752	1,002	1,336	2,133	2,646
	O	0	185	468	611	772	1,054
d. SPENDING INCREASES (AUTHORIZATIONS)							
Airport and Airway System Development Act (function 400):							
Facilities and equipment		261	725	1,393	1,407	1,377	1,164
Research, engineering and development		72	134	268	269	215	193
Operations		800	1,559	1,335	1,363	1,388	1,444
Weather services		0	27	29	31	33	35
Security screening		10	0	0	0	0	0
Total authorization		1,143	2,445	3,025	3,070	3,013	2,836
Less: Amounts already appropriated		1,117	0	0	0	0	0
Net additional authorization		26	2,445	3,025	3,070	3,013	2,836
Estimated outlays		18	1,635	1,982	2,483	2,880	3,029
Food stamps (function 600): Impact of AFDC and SSI proposals:							
Estimated authorization		0	190	208	213	217	222
Estimated outlays		0	190	208	213	217	222
Total for provisions resulting in spending increases (authorizations):							
Authorization		26	2,635	3,233	3,283	3,230	3,058
Outlays		18	1,825	2,190	2,696	3,097	3,251
Total:							
Authorization/budget authority		344	1,955	2,262	2,192	2,751	1,856
Outlays		18	−2,153	−3,239	−3,824	−5,320	−7,046

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[1] Budget authority shown under spending increases.

[2] Less than $1,000,000.

Some sections in this bill would reduce future federal liabilities through changes to existing entitlements and therefore could permit subsequent appropriations' actions to reduce the budget authority for these programs. The figures shown as "Budget Authority" (BA) represent those amounts by which budget authority could be reduced, as a result of this bill, below the levels needed under current law.

6. Basis of estimate: The savings shown for this bill are estimated based on draft legislation. Detail on the bases of the estimates is available from CBO staff.

Certain proposed changes in some programs cause outlays in other programs to change. For example, reductions in benefits to recipients in the AFDC program cause outlays in the Food Stamp program to increase. Most AFDC recipients receive food stamps and the amount of a recipient family's food stamp benefit depends on the family's income. In addition, when changes in the AFDC program make families ineligible for AFDC, they often lose Medicaid benefits, causing Medicaid outlays to decrease. Such changes in outlays are shown in the cost estimate table. In the case of Food Stamps, such increases are relative to CBO's baseline estimates that assume continuation of the current program.

7. Estimate comparison: None.

8. Previous CBO estimate: None.

9. Estimate prepared by: Thomas Buchberger, Hinda Ripps Chaikind, Malcolm Curtis, Richard Hendrix, Marilyn Moon, Janice Peskin, Lisa Potetz, Charles Seagrave, Robert Sunshine.

10. Estimate approved by:

C. G. NUCKOLS
(For James L. Blum,
Assistant Director for Budget Analysis).

VOTE OF THE COMMITTEE

In compliance with section 133 of the Legislative Reorganization Act of 1946, the committee states that the spending reduction provisions of the bill were ordered favorably reported by a vote of 13 ayes and 6 nays.

V. Regulatory Impact of the Spending Reduction Provisions

SECTIONS A–C—HEALTH PROVISIONS

In compliance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the committee states that the provisions of the bill related to Medicare, Medicaid, and Utilization and Quality Control Peer Review will not impact on the personal privacy of individuals.

In implementing certain cost saving provisions of the bill there will be some increase in Federal regulatory activity. It is not anticipated, however, that the legislation would impose an unusual or burdensome regulatory effect. Several provisions will, in fact, decrease regulatory activity and associated paperwork.

Four provisions related to Medicare (sections 107, 115, 116, and 118) and two related to Medicaid (sections 132 and 135) are expected to decrease regulatory activity and associated paperwork. Ten medicare provisions, two Medicaid provisions, and the utilization and quality control provision will impose a minimal regulatory effect. Five medicare provisions (sections 102, 108, 110, 114, and 120) and one Medicaid provision (section 133) will require the promulgation of new regulations in order to implement these significant changes in program policy. The paperwork associated with these six provisions will be significant but is not expected to be burdensome.

SECTIONS D–G—INCOME SECURITY

D. Aid to Families With Dependent Children

Setcions 151–154, 158 and 161–162 are expected to have, at most, a minimal impact on regulatory burden and paperwork for States. Sections 154–156, 159 and 160 will place an increased regulatory, financial, and paperwork burden on States complying with these provisions. It is not anticipated, however, that these provisions would impose an unusual or burdensome regulatory impact. Sections 155, 156, 158, and 160 would impose greater reporting requirements on recipients seeking to comply with federal law and regulation. A number of the provisions would have economic impacts on certain recipients in the form of lower benefit amounts (sections 150, 151, 156–158) or benefits that would not be paid because eligibility requirements would no longer be met (sections 153–156, 160).

E. Child Support Enforcement

Section 171 of the title E would decrease the Federal regulatory burden and resulting paperwork for State agencies by repealing a provision in current law which States have reported difficult to implement because of legislative barriers and administrative difficulties.

Section 172 would increase Federal regulatory activity and paperwork, but only minimally. Section 173 would decrease the regulatory and financial burden on States.

F. Supplemental Security Income

Sections 181, 182, 184 and 185 of title F are expected to have, at most, only a minimal impact on Federal regulatory activity. Section 183 should reduce the Federal regulatory, financial, and paperwork burden by correcting a flaw in current law and ensuring that SSI accounting procedures operate more efficiently. Sections 181 and 182 would have a relatively minor economic impact on recipients resulting in slightly lower future benefit amounts.

G. Unemployment Compensation

Section 191 of title G is not expected to place any significant Federal regulatory burden on the States. It may result in slightly lower benefit amounts if States choose to incorporate this provision into their laws.

VI. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the spending reduction provisions in H.R. 4961, as reported by the committee).

PART TWO: REVENUE PROVISIONS

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I. SUMMARY OF REVENUE PROVISIONS

Overview

The Tax Equity and Fiscal Responsibility Act of 1982, as reported by the Finance Committee, provides for net revenue increases of $20.9 billion in fiscal year 1983, $34.2 billion in 1984, and $43.9 billion in 1985. These figures are consistent with the revenue increase targets mandated in the First Concurrent Budget Resolution for fiscal year 1983. This revenue increase is provided in a fashion that will insure that all individuals and businesses pay a fair share of the tax burden, that distortions in economic behavior which result from the present tax system are reduced, and that those responsible for specific Federal government spending programs pay a greater share of that spending.

The principal provisions of the bill are as follows:

- Expansion of the alternative minimum tax for individuals, and repeal of the add-on minimum tax for individuals, to insure that high income individuals with preference income cannot avoid some tax liability.
- Restrictions in the medical expense and casualty loss deductions so that expenses under either provision are deductible only to the extent that they exceed 10 percent of adjusted gross income.
- Reduction in the holding period for long-term capital gains from 1 year to 6 months.
- A 15-percent reduction in various corporate tax preferences.
- Reduction in the basis of assets, for cost recovery and other purposes, by one-half of the investment credits earned for these assets.
- Elimination of the further accelerations in ACRS cost recovery deductions scheduled for 1985 and 1986.
- A requirement that corporations amortize over 10 years the construction period interest and taxes of real property other than nonresidential structures.
- Restrictions on the buying and selling of tax benefits through safe-harbor leasing and termination of safe-harbor leasing after September 30, 1985.
- Changes in the taxation of foreign oil income of U.S. corporations to prevent extraction losses from eliminating tax on other income and to tax non-extraction oil-related income in the year it accrues.
- Restricting the possession corporation credit to companies which have at least 90 percent of income from an active trade or business and denying the credit for income from intangibles.
- Slower cost recovery deductions for certain assets financed with industrial development bonds, and requirements for public hearings and reporting with respect to those bonds, and the termination of small issue bonds after 1985. Various changes also would be made in the restrictions on the issuance of tax-exempt bonds for single-family housing.

- Tightening of the rules governing the tax treatment of mergers and acquisitions.
- Restrictions on the deductions which may be taken by taxpayers using the completed contract method of accounting prior to the year in which the income is recognized.
- A change allowing certain partnerships which grow crops, the partners of which are corporations, to be treated the same as a corporation for purposes of the annual accrual accounting method rules.
- Repeal of the exclusion for dividends reinvested in public utility stock.
- Elimination of the favorable tax treatment given to original issue discount and stripped coupon bonds.
- Extension and expansion of the targeted jobs credit.
- Changes requiring corporations to pay a higher percentage of tax liability for a year in the estimated payments for that year.
- Withholding on interest and dividends at a 10-percent rate, with special provisions for low-income persons, elderly persons, and small financial institutions.
- Changes in various reporting requirements and penalties to improve compliance with the tax laws.
- Restrictions on the amounts which can be accumulated tax-free under pension plans and on the amount which beneficiaries may borrow from the plans.
- Various changes in the taxation of life insurance companies, including repeal of the provision allowing favorable tax treatment of modified coinsurance arrangements.
- Establishment of a safe-harbor test that, if satisfied, results in classification of an individual as an independent contractor for Federal employment purposes (other than under the Railroad Retirement Tax Act).
- An increase in the base of the FUTA tax from $6,000 to $7,000 of wages per year and an increase in the net Federal rate from 0.7 to 0.8 percent.
- Extension of medicare tax and medicare coverage to Federal employees.
- Increases in various aviation excise taxes, with receipts transferred to the Airport and Airway Trust Fund.
- An increase in the telephone tax from 1 percent to 2 percent in 1983, 3 percent in 1984 and 1985, and 2 percent thereafter.
- A doubling of the cigarette tax from 8 to 16 cents per pack.
- Expansion of items subject to the excise tax on fishing equipment, and a new excise tax on recreational boats and boating equipment, with the revenues to be earmarked for the Dingell-Johnson program.
- Repeal of the special pipeline tariff adjustment, under the windfall profit tax, for oil flowing through the Trans-Alaska Pipeline System (TAPS).
- Extension for two years of the exclusion from income of National Research Service Awards.
- Exemption from divestiture requirements applying to the private foundations which own the Broadmoor Hotel and the Houston Chronicle.
- Allowance of deductions for payments to foreign agents and officials which do not violate the Foreign Corrupt Practices Act.

- An increase of $40 billion in Treasury's authority to issue long-term bonds with interest rates above 4¼ percent and repeal of the limitations on interest rates payable on savings bonds.
- Studies of (1) alternative tax systems which are simpler and have a broader base than the current system, and (2) the use of debt growth and total liquid assets as targets of monetary policy.
- A technical change in the allocation of revenue sharing payments among various units of local government in New Jersey.
- Settlement of claim for repayment of certain social security taxes to the Jefferson County Mental Health Center, Lakewood, Colorado.

Summary of Revenue Provisions

Individual Income Tax Provisions

Individual minimum tax

In order to reduce the extent to which high-income people can avoid paying income tax, the bill repeals the add-on minimum tax for individuals and expands the existing alternative minimum tax. All present law preferences, under the existing add-on and alternative minimum taxes, except adjusted itemized deductions, are included in the base of the expanded alternative minimum tax. To calculate minimum taxable income, preference amounts are added to adjusted gross income, and deductions are allowed for charitable contributions, medical expenses, casualty losses, home mortgage interest, other interest to the extent of investment income, and real net operating losses.

Under the bill, the first $30,000 of minimum taxable income ($40,000 on joint returns) is exempt from the alternative minimum tax. Minimum taxable income in excess of $30,000 but less than $50,000 ($40,000–$60,000 for couples filing joint returns) is taxed at a 10-percent rate, and the excess is taxed at a 20-percent rate. Several new preferences are added: excluded interest and divided income (including interest on tax-exempt bonds issued after December 31, 1982) and the excess of expensing over 10-year amortization for mining exploration and development costs, research and development costs and magazine circulation and prepublication expenditures.

The bill allows individuals, other than limited partners, producing oil and gas to elect to depreciate intangible drillings costs under the rules for the 5-year ACRS class with an investment credit but without safe-harbor leasing.

This provision will increase revenues by $0.2 billion in fiscal year 1984 and $0.3 billion in 1985.

Casualty and medical deductions

The bill restricts the availability of two itemized deductions—medical expenses and casualty losses—which generate considerable complexity for many taxpayers.

The bill provides that casualty losses will be deductible only to the extent total losses sustained during the year exceed 10 percent of adjusted gross income. Casualty losses smaller than $100 will continue to be nondeductible.

The bill raises the floor for deductible medical expenses from 3 percent to 10 percent of adjusted gross income.

These changes will increase revenues by $0.3 billion in fiscal year 1983, $3.0 billion in 1984, and $3.2 billion in 1985.

Capital gains holding period

The bill reduces the holding period distinguishing long-term from short-term capital gains and losses from one year to six months.

The revenue loss is expected to be $0.1 billion in fiscal year 1983, $0.2 billion in 1984, and $0.2 billion in 1985.

Business Tax Provisions

The bill contains several provisions which significantly reduce business tax preferences which the committee believes to be excessive, in light of the budget situation, or counterproductive.

Corporate minimum tax preferences

The bill reduces the following corporate tax preferences by 15 percent: percentage depletion for coal and iron ore, excess bad debt reserves, interest on debt used to carry tax-exempt securities acquired after 1982, deferred DISC income, section 1250 recapture on structures, rapid amortization of pollution control facilities, intangible drilling costs of integrated oil companies, and mineral exploration and development costs. Under the bill, integrated oil producers are allowed to expense up to 85 percent of intangible drilling costs. The remainder will be written off under the ACRS 5-year recovery percentages with an investment credit but without safe harbor leasing. (Fifteen percent of mineral exploration and development costs will be recovered under these ACRS rules as well.) Rules are provided to prevent preferences from being cut back excessively through the interaction of this provision and the add-on minimum tax.

These changes will increase revenues by $0.5 billion in fiscal year 1983, $0.8 billion in 1984, and $0.8 billion in 1985.

Investment tax credit

The bill provides that taxpayers must reduce the basis of assets by one-half of the amount of regular, historic rehabilitation and energy investment tax credits for the assets. This lower basis is used, for example, to compute cost recovery deductions and gain or loss when the asset is sold or exchanged. The basis adjustment will have the desirable effect of ensuring that the combination of cost recovery deductions and investment tax credits does not exceed the value of expensing the cost of the asset in the year it is placed in service.

The limit on the amount of tax which may be offset by the investment tax credit for both individuals and corporations is reduced from 90 percent to 85 percent.

This provision will increase revenues by $0.5 billion in fiscal year 1983, $1.7 billion in 1984, and $3.0 billion in 1985.

1985 and 1986 ACRS changes

The bill eliminates the 1985 and 1986 further acceleration of depreciation scheduled for property placed in service after 1984. This, too, is needed to keep the system no more generous than expensing.

This provision will increase revenues by $1.6 billion in fiscal year 1985.

Construction period interest and taxes

The bill requires corporations to amortize over 10 years interest and real property taxes incurred in the construction of nonresidential real property.

This provision will increase revenues by $0.6 billion in fiscal year 1983, $1.2 billion in 1984, and $1.3 billion in 1985.

Safe harbor leasing

The bill substantially modifies the safe harbor leasing rules to reduce their revenue impact and eliminate abuses:

A 50-percent limitation is imposed on the percentage of tax liability that a lessor may avoid through the use of safe harbor leasing, and lessors are not permitted to carry back tax benefits obtained as safe-harbor to lessors prior tax years.

The bill lowers the maximum interest rate on obligations of the lessor to the lessee in a safe harbor sale-leaseback to 5 percentage points less than the interest rate on overpayments and underpayments of tax.

The maximum lease term is reduced to 100 percent of the ADR midpoint life of the asset.

The maximum percentage of eligible property that may be leased by any lessee in a safe-harbor lease is set at 45 percent in 1982 and 1983 and 40 percent in 1984 and 1985.

Property leased under the safe-harbor rules is depreciated under the cost recovery methods and periods provided for the minimum tax.

The bill provides that the investment tax credits earned on leased property are allowed over 3 years—50 percent the first year and 25 percent in each of the next 2 years.

The bill prohibits the use of leasing to increase foreign tax credits and percentage depletion and prohibits lease between related parties.

The bill provides that safe harbor leasing is not available for public utility property.

Under the bill, certain tax exempt entities are not permitted to structure transactions to benefit from leasing.

Starting January 1, 1985, all leases will be permitted to include a fixed price purchase option at the end of the lease term of at least 10 percent of the original cost.

Mass transit leasing is permitted for property placed in service on or before December 31, 1987, for property purchased under certain binding contracts or commitments entered into on or before March 31, 1983.

So-called investment tax credit strips entered into before October 20, 1981 are permitted.

The bill prevents the Internal Revenue Service from retroactively denying lease treatment under rules in effect prior to safe-harbor leasing for motor vehicle operating leases involving business users by reason of the fact the lease contained a terminal rental adjustment clause. However, Treasury is not to be prevented from issuing rules on a prospective basis that preclude lease treatment for such leases. The provision applies on a retroactive basis to any open taxable year.

The bill repeals safe-harbor leasing after September 30, 1985.

These rules are generally effective after July 1, 1982, except for certain anti-abuse rules, which are generally effective after February 19, 1982. Appropriate transition rules are provided.

This provision will increase revenues by $1.1 billion in fiscal year 1983, $2.9 billion in 1984, and $4.2 billion in 1985.

Foreign oil and gas income

The bill makes a series of changes to prevent oil producers from using their extraction activities abroad to avoid tax on non-extraction income. It repeals the country-by-country loss feature of the rule for the foreign tax credit limitation affecting oil and gas extraction income. Oil companies thus are not permitted to use credits arising out of their foreign oil and gas extraction activities to shelter other income from U.S. tax.

The bill expands the present anti-tax haven rules (subpart F) so that oil companies are generally subject to tax currently on their foreign non-extraction oil income related to activities carried on in countries other than those where the oil and gas is extracted or consumed. U.S. tax on foreign shipping income will continue to be deferred to the extent the income is reinvested in shipping assets.

This provision will increase revenues by $0.2 billion in fiscal year 1983, $0.5 billion in 1984, and $0.6 billion in 1985.

Possessions credit limitation

The bill makes several changes to limit abuses of the present tax credit for income earned in U.S. possessions. It provides that income of a corporation that qualifies for the possession credit does not include income allocable to intangibles. Such income will be allocated to the U.S. affiliates of a qualifying corporation or to the qualifying corporation itself as non-creditable U.S. source income. In addition, the current rule that permits a qualifying corporation to earn up to 50 percent passive income is changed to permit only 10 percent passive income. Similar rules are provided for U.S. corporations effectively exempt from tax because they are inhabitants of the Virgin Islands.

This provision will increase revenues by $0.4 billion in fiscal year 1983, $1.0 billion in 1984, and $1.3 billion in 1985.

Industrial development and mortgage subsidy bonds

The bill contains a number of restrictions on the use of tax-exempt bonds for private activities in order to improve the use of these bonds. It provides reporting requirements for all private activities bonds. A public hearing and approval by an elected official or legislature is required for all industrial development bonds (IDBs). The cost of IDB-financed property placed in service after December 31, 1982 (except for property financed by bonds issued before July 1, 1982 or certain rollovers of such bonds, or property which is part of a facility under construction by July 1, 1982) generally will be required to be recovered under the straight-line depreciation method over present law minimum tax lives with a 25-year life for nonresidential structures. Exceptions are provided for low-income housing, for municipal solid waste facilities, for new pollution control equipment to be used in connection with a plant in operation on or before July 1, 1982, and for facilities with respect to which a UDAG grant is made. Bonds are not permitted under the $1 million small issue limit as part of an issue which includes bonds which are tax-exempt under other provisions. Certain composite issues are permitted. Certain research and development expenditures are not treated as capital expenditures for purposes of the $10 million capital expenditure limit on small-issue IDBs. Small issue IDBs cannot be issued after 1985.

The bill allows tax-exempt industrial development bonds for local district heating or cooling facilities which use water or steam and for facilties that provide gas to a service area comprised of no more than a city and one contiguous county or two contiguous counties.

The bill makes the following changes to the restrictions on the use of tax-exempt bonds for single-family housing imposed by the Mortgage Subsidy Bond Tax Act of 1980: (1) the arbitrage limitations are increased from 1.0 percentage points to 1 1/16 to 1 1/8 percentage points depending upon the size of the bond issue, (2) distributions of arbitrage on nonmortgage investments are required to the extent that they require recognition of a loss in excess of undistributed arbitrage on nonmortgage investments at such time, (3) the 3-year rule is applied to 80 percent of the bond proceeds, and (4) the purchase price limitations are increased from 90 percent of area average purchase price (110 percent in targeted areas) to 110 percent (120 percent in targeted areas).

This provision will increase revenues by $0.1 billion in fiscal year 1983, $0.4 billion in 1984, and $0.8 billion in 1985.

Mergers and acquisitions

Recently, several very large corporate takeovers have highlighted potential tax advantages for certain transactions, including mergers and acquisitionss. The bill eliminates several rules of present law that may produce these advantages.

The bill generally repeals the partial liquidation provisions of present law. The vagueness of the standards applicable permits an unwarranted degree of selectivity in choosing assets to be distributed in partial liquidation. The rules applicable to such distributions permit a step-up in the basis of such assets without the tax consequences normally incident to a disposition of property. Capital gain treatment is retained for noncorporate shareholders who receive property from a trade or business conducted for at least 5 years by the distributing corporation (currently defined as a partial liquidation).

The bill also repeals certain exceptions from the general rule that gain is recognized when appreciated property is used to redeem the stock of a distributing corporation. This change will prevent stock redemptions from being used to avoid the tax consequences that would apply on a direct sale of the distributed assets. The elimination of these exceptions and the partial liquidation rules is not intended to change the rules of present law applicable to a redemption the substances of which may be a direct sale of assets.

The bill replaces the present law rules for treating the acquisition of a controlled corporation as an asset acquisition with a new elective provision no longer requiring a liquidation. Within 75 days after a purchase of 80 percent or more of the stock of an acquired corporation, a corporate purchaser may elect to treat the acquired corporation as if it had sold all of its assets in a complete liquidation on the date of the stock purchase. The acquired corporation's tax attributes will be terminated, and the basis of its assets will be adjusted, as of the stock acquisition date, to reflect the price paid for its stock.

The bill requires consistent treatment where an acquiring corporation or affiliated group of corporations acquires stock in two or more corporations that are members of the same affiliated group. If a purchase of assets (other than in the ordinary course of business) is made from a corporation, the bill treats an acquisition of stock of the same corporation or of a member of the same affiliated group as a purchase of assets. Regulations are authorized to prevent the circumvention of this requirement of consistent treatment through the use of other provisions of a law or regulations.

Generally, the provisions relating to mergers and acquisitions apply to property distributions after August 31, 1982, and acquisitions of target corporations after August 31, 1982. The new rules do not apply to any case in which a tender offer for the target corporation was outstanding on July 1, 1982, or an acquisition pursuant to a binding contract entered into on or before July 1, 1982.

This provision will increase revenues by $0.7 billion in fiscal year 1983, $0.8 billion in 1984, and $0.7 billion in 1985.

Completed contract method of accounting

The bill instructs the Treasury to amend its regulations relating to the completed contract method of accounting for long-term contracts, the use of which permits significant tax deferral on income from such contracts. The amended regulations will address certain problems relating to the determination of when a contract is considered completed and the determination of whether contracts should be treated as one or several contracts.

The amended regulations also will require that taxpayers generally must allocate additional costs to long-term contracts with an estimated incompletion date of more than 2 years. However, a taxpayer engaged in a long-term contract for the construction will not be subject to the new cost allocation rules if either the construction contract is expected to be completed within 3 years or less, or the taxpayer's average annual gross receipts are $25 million or less for the 3 preceding taxable years.

The new termination, segregation and aggregation rules generally apply to taxable years ending after December 31, 1982. The cost allocation rules will apply to contracts entered into after December 31, 1982. During a transition period, a portion of the indirect costs that will be require dto be allocated to long-term contracts by reason of the amended regulations will continue to be currently deductible. The portion of indirect costs that will continue to be currently deductible is as follows:

For taxable years beginning in:	The percentage of indirect costs that continue to be currently deductible is
1983	66⅔
1984	33⅓
1985 and thereafter	0

This provision will increase revenues by $0.9 billion in fiscal year 1983, $2.2 billion in 1984, and $2.5 billion in 1985.

Dividend reinvestment plans for utilities

The bill repeals the exclusion for dividends reinvested in public utility stock, effective for distributions made after December 31, 1982.

This provision will increase revenues by $0.1 billion in fiscal year 1983, $0.4 billion in 1984, and $0.4 billion in 1985.

Modified treatment of original issue discount bonds and stripped coupon bonds

In the past year, there has been a rapid increase in two types of transactions motivated, to a large extent, by tax considerations: issuance of deep-discount bonds and coupon stripping. The bill rationalizes the rules in these areas to eliminate the tax motivation for doing these transactions.

The bill replaces the present linear formula for amortization of original issue discounts with a formula which approximates the way in which interest accrues under borrowing with ordinary bonds. Also, the rules that govern amortization of original isssue discount on bonds issued by corporations will be extended to certain non-corporate bonds. The bill provides that taxpayers who strip coupons from bonds will allocate basis between the coupons and the corpus of the bonds (i.e., the right to receive the principal amount of the bond at maturity) with the result that no artificial loss may be created through sale of the detached corpus. The retained portion of the stripped corpus or coupons will be treated as an original issue discount bond, requiring periodic inclusion of discount income. Purchasers of stripped corpus or coupons also will be treated as having purchased OID bonds. The effective date for these proposals are those announced in the relevant Treasury Department news releases issued on May 3, 1982 and June 9, 1982.

This provision will increase revenues by $0.2 billion in fiscal year 1983, $0.3 billion in 1984, and 0.5 billion in 1985.

Acceleration of corporate income tax payments

The bill accelerates the collection of corporate estimated income taxes by (1) increasing the amount of estimated tax payments needed to avoid the estimated tax penalty from 80 percent to 90 percent of the actual tax due, (2) requiring that all remaining tax owed be fully paid on the return due date, and (3) requiring large corporations (those with over $1 million of taxable income in any one of the three preceding years) which base their estimated tax payments on the prior year's income or tax liability, to pay at least 85 percent of their current year's tax liability in 1985 and 90 percent in 1986 and thereafter. In addition, the penalty on underpayments of estimated tax will be one-half the full rate for underpayments on the portion of the underpayment between 80 and 90 percent of actual tax due.

This provision will increase revenues by $0.8 billion in fiscal year 1983, $1.1 billion in 1984, and $1.5 billion in 1985.

Compliance Provisions

The bill contains a number of very important changes designed to achieve a significant reduction in noncompliance with the tax laws. The committee adopted these far-reaching changes because it believes that it would be grossly unfair to increase the tax burden of the vast majority of honest Americans without making every reasonable effort to collect the tax that is owed under existing laws.

Withholding on interest and dividends

The bill requires withholding at a flat rate of 10 percent on payments of interest and dividends. Payments to certain tax-exempt institutions, corporations, low income elderly individuals, and interest payments made by individuals are generally exempted. In addition, the bill exempts individuals with no income tax liability in the preceding taxable year.

The bill provides the Treasury Department with authority to set the frequency of deposits of taxes withheld on interest income and to exempt small banks until it determines that they can comply with withholding.

This provision will increase revenues by $4.3 billion in fiscal year 1983, $3.6 billion in 1984, and $4.1 billion in 1985.

Taxpayer compliance improvements

The bill contains a series of provisions designed to encourage complete and accurate reporting of income and deductions. These include provisions improving information reporting, increasing penalties for noncompliance, amending the methods under which interest on tax deficiencies and overpayments is computed, substantially revising the withholding rules for pension distributions and revising certain rules governing information gathering by the Internal Revenue Service.

The bill includes a sense of the Congress resolution that additional funds be appropriated to the Internal Revenue Service to provide the staff proposed by the Administration and additional staff over that requested by the Administration's 1983 Budget sufficient to collect at least $1 billion in fiscal year 1984 and $2 billion in fiscal year 1985 over the amount which would be collected in the absence of such improved enforcement.

This provision, not including the additional staff, will increase revenues by $2.4 billion in fiscal year 1983. $3.4 billion in 1984, and $4.6 billion in 1985.

Pension Provisions

The current law permits high-income people to receive substantial tax-favored benefits from pension plans, benefits which are unavailable to middle-income people. With lower taxes on investment income because of the reduction in the top marginal tax rate to 50 percent, these pension benefits should be scaled down, and there should be greater parity between corporate and noncorporate plans. The bill makes a number of changes in the pension provisions of the Code to accomplish these goals.

The bill makes several changes affecting the overall limits on contributions and benefits under tax-qualified pensions. The bill (1) reduces the maximum annual addition for profit-sharing and other defined contribution plans from $45,475 to $30.000; (2) reduces the maximum annual retirement benefit under a defined benefit pension plan from $136,425 to $90,000; (3) increases the maximum deductible contribution limit for defined contribution H.R. 10 plans from $15,000 in 1982 to $20,000 in 1983, $25,000 in 1984, and $30,000 in 1985; (4) provides adjustments for post-1984 inflation, beginning in 1986, for the limits on all plans (including corporate and H.R. 10 plans) based upon the social security benefit index formula then in effect; (5) increases the age below which actuarial reductions are required in the maximum benefit limit for defined benefit plans from 55 to 62; (6) reduces the overall limit where both a defined contribution and defined benefit plan are provided from 1.4 to 1.25 with respect to the dollar limits only; and (7) places a $10,000 limit on outstanding loan balances of plan participants under all qualified plans and requires reporting to the Internal Revenue Service by plans with respect to participant loans. The bill does not affect benefits already earned under a plan or loans already made.

The bill permits an employer to provide additional contributions on behalf of disabled participants (other than officers, shareholders and highly compensated individuals), based upon their pre-disability compensation. These participants are immediately vested in their accrued benefit derived from those additional contributions.

Under the bill, participants in a qualified State judicial plan will not be subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited. In addition, certain rules and qualifications are made applicable to State judicial plans.

The bill permits churches to provide certain retirement savings arrangements to their employees, subject to revised limitations.

This provision will increase revenues by $0.2 billion in fiscal year 1983, $0.6 billion in 1984, and $0.7 billion in 1985.

Life Insurance Company Taxation

The tax treatment of life insurance, the main features of which were established in 1959, is in need of re-examination. The bill provides a number of legislative changes to rationalize the treatment of life insurance. To encourage a re-examination of this complex issue, many of these changes are terminated after 2½ years.

The bill includes a series of provisions affecting the taxation of life insurance companies and their products. The bill repeals the modified coinsurance ("Modco") rules in section 820; treats existing Modco agreements as terminated on January 1, 1982, allowing a 3-year recapture rule for certain reinsurers; provides related party allocation authority for Treasury for future conventional coinsurance agreements; prevents tax avoidance by disallowing an interest deduction with respect to conventional coinsurance funded by a debt obligation; and grandfathers prior Modco transactions except in the event of fraud.

The committee bill also amends certain provisions of existing law that are not working as originally intended because of changed circumstances since 1959 when those provisions were enacted, i.e., higher interest rates, changed mortality experience and a more inflationary economic environment. These amendments would be effective only for a 3-year stopgap period, during 1982 through 1984, to permit a comprehensive congressional review of the insurance company tax laws.

For the stopgap period, the committee's bill raises the present $250,000 special deductions limit to $1,000,000, imposes an affiliated group limit and targets the provision to smaller companies. It also allows a 100-percent deduction for policyholder dividends credited for qualified pension business.

Under the bill, life insurance companies are allowed to deduct a minimum of 77½ percent of policyholder dividends on business other than qualified pension, etc. business. Stock life insurance companies are allowed a minimum policyholder dividend and interest deduction of 85 percent of amounts paid or credited on their nonqualified business.

A geometric "Menge" formula is provided to compute adjusted life insurance reserves for purposes of the allocation rules used to determine policyholders' share of investment yield excludable from taxable investment income.

A "bottom-line" method of consolidation is allowed for determining consolidated life insurance company taxable income.

The committee bill revises the approximate revaluation formula for revaluing preliminary term reserves by reducing the revaluation from $21 to $19 per $1,000 of other than term insurance in force, for business written after March 31, 1982. Under the bill, no reserve deductions are allowed for interest guaranteed beyond the annual valuation date.

The tax treatment for modified coinsurance transactions with a section 820 election for periods prior to January 1, 1982 is grandfathered except in cases of fraud. Excess interest credited to policyholders for years prior to 1982 will be fully deductible. Similarly, treatment claimed with respect to consolidation of two or more life insurance companies is grandfathered for years prior to 1982.

The committee bill prescribes guidelines for eligibility of the proceeds from "universay life" products for the income tax death benefit exclusion and, except for grandfather protection for prior periods, does not prescribe the tax treatment of excess interest (leaving the issue open for litigation during the stopgap period as to characterization as fully deductible interest paid or as a policyholder dividend deductible to the extent allowed under the percentage limitation safety net).

Under the bill, no reserve deductions are allowed for interest guaranteed beyond the annual valuation date.

The bill permanently modifies the recipient's tax treatment of annuities. Withdrawals are deemed to be taxable to the extent income from investment has been earned. A rule for treating loans as distributions and a 10-percent penalty for withdrawals prior to age 59½ or within 10 years of contribution, whichever period is shorter, is also added. A 100-percent excess interest deduction is allowed to insurance companies for amounts credited to deferred annuity business.

All of the above provisions terminate after 1984 except for the treatment of modified coinsurance and related transactions and deferred annuities and the "grandfather" rules.

This provision will increase revenues by $1.5 billion in fiscal year 1983, $1.5 billion in 1984, and $2.2 billion in 1985.

Employment Tax Provisions

Independent contractors

The bill establishes a safe-harbor test that, if satisfied, results in classification of an individual as an independent contractor for Federal employment tax purposes (other than under the Railroad Tax Act). If all five requirements of the test are met with respect to service performed by an individual, then that service is treated as performed by an individual who is not an employee, and the service-recipient (i.e., the person for whom services are performed) is not treated as an employer with respect to that service. The safe-harbor requirements relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns. The failure of a worker to satisfy the safe-harbor test will not affect his or her classification under the common law rules.

The bill also provides for reduction of employment tax liabilities in situations involving the reclassification of workers as employees and provides for Tax Court jurisdiction over employment tax disputes.

This provision reduces fiscal year receipts by $0.2 billion in 1983 and $0.1 billion in 1984, and increase receipts by $0.1 billion in 1985.

Federal unemployment tax

The bill modifies the Federal employment insurance tax to reduce the deficits of the unemployment insurance program. Effective January 1, 1983, the FUTA wage base is increased to $7,000 and the tax rate is increased to 3.5 percent. Effective January 1, 1985, the Federal tax rate is increased to 6.2 percent (a permanent tax of 6.0 percent and an extended benefit tax of 0.2 percent) and the credit which employers receive against the tax is increased to 5.4 percent. The progressive reduction of the FUTA credit applicable to States in default is retained as under current law.

This provision will increase revenues by $1.4 billion in fiscal year 1983, $2.4 billion in 1984, and $2.9 billion in 1985.

Extension of Social Security hospital insurance taxes and medicare coverage to Federal employees

Most Federal employees eventually qualify for medicare; however, they are currently exempt from the medicare tax. Under the bill, Federal employees will be subject to the FICA hospital insurance tax. (The tax is imposed at the rate of 1.3 percent of wages received during 1982–1984, 1.35 percent of wages received during 1985, and 1.45 percent of wages received after December 31, 1985.) Federal employees will also receive medicare coverage after paying hospital insurance taxes for the required period of time.

This provision will increase revenues by $0.6 billion in fiscal year 1983, $0.8 billion in 1984, and $0.9 billion in 1985.

Excise Tax Provisions

Airport and airway tax measures

Under present law, no tax revenues are being transferred to the Airport and Airway Trust Fund. Under the bill, the following aviation excise taxes are designated for the Trust Fund: (1) an 8-percent passenger ticket tax (increased from the present 5-percent rate); (2) a 12-cents-per-gallon tax on noncommercial aviation gasoline (increased from the present 4-cent rate); (3) a 14-cents-per-gallon tax on nongasoline fuels for noncommercial aviation (no tax under present law); (4) a 5-percent air freight waybill tax (no tax under present law); (5) a $3 per person international departure ticket tax (no tax under present law); and (6) amounts equal to revenues from the present taxes on aircraft tires and tubes. Certain helicopters engaged in natural resources and timber operations not using Federal-aid or Federal facilities will be exempt from the fuel taxes. The tax changes apply to tickets and to fuels purchased after August 31, 1982.

The aviation tax provisions will increase revenues by $0.8 billion in fiscal year 1983, $1.0 billion in 1984, and $1.1 billion in 1985.

In addition, the committee approved a separate provision (title IV) regarding the Airport and Airway System Development Act which would: (1) authorize expenditures for certain capital improvements to airports; (2) authorize certain expenditures for Federal Aviation Administration programs; (3) establish a state block grant program; (4) require the Secretary of Transportation to study an airport defederalization program; and (5) permit airports to voluntarily withdraw from the Federal airport improvement program. Title IV provides Trust fund program authorizations for fiscal years 1982–1987. (See Volume 2 for an explanation of these provisions.)

Telephone excise tax

The bill increases the telephone excise tax to 2 percent in 1983, 3 percent in 1984, 3 percent in 1985, and 2 percent for years after 1985.

This provision will increase revenues by $0.3 billion in fiscal year 1983, $0.9 billion in 1984, and $1.6 billion in 1985.

Cigarette excise tax

The bill increases the present Federal excise tax on small cigarettes from $4 to $8 per thousand (from 8 to 16 cents per package). The tax on large cigarettes is increased from $8.40 to $16.80 per thousand.

This provision will increase revenues by $1.3 billion in fiscal year 1983, $1.8 billion in 1984, and $1.9 billion in 1985.

Expansion of Dingell-Johnson Fund taxes

The bill expands the articles of fishing equipment which are subject to the 10-percent manufacturers excise tax and imposes a 3-percent excise tax on recreational fishing boats and boating equipment, with the revenues to be available for expansion of the Dingell-Johnson Fund program. The provision also amends the time for payment of the excise tax on fishing equipment.

Repeal of TAPS adjustment for crude oil windfall profit tax

Oil produced at Prudhoe Bay in Alaska would be treated like other oil under the windfall profit tax by repealing the special Trans-Alaska Pipeline System (TAPS) adjustment presently applicable to that oil.

This provision will increase revenues by $0.1 billion in fiscal year 1983, $0.1 billion in 1984, and $0.2 billion in 1985.

Miscellaneous Provisions

National Research Service Awards

The bill extends for two additional years (to awards made through 1983) the income tax exclusion for National Research Service Awards.

El Pomar Foundation

The El Pomar Foundation of Colorado Springs, Colorado, would be exempt from the divestiture requirements of the excise business holdings provision imposed on private foundations by the Tax Reform Act of 1969.

Houston Endowment

The Houston Endowment of Houston, Texas, would be exempt from the divestiture requirements of the excess business holdings provision imposed on private foundations by the Tax Reform Act of 1969.

Annual accrual accounting for certain joint ventures

Under the bill, a "qualified" partnership (a partnership composed entirely of corporations other than subchapter S corporations or personal holding companies) will be treated the same as a corporation for purposes of the annual accrual accounting method rules. Thus, a corporation that is allowed to use the annual accrual accounting method for the business of growing a crop such as sugarcane could transfer substantially all of the assets of the business to a qualified partnership in exchange for an interest in the partnership, and the qualified partnership will be allowed to use the annual accrual method to compute the taxable income from the transferred business.

Targeted jobs tax credit

The targeted jobs tax credit is extended for three years. The credit is made available with respect to any member of a targeted group who begins work on or before December 31, 1985.

In addition, the jobs credit is modified to encourage summer youth employment. Employers will receive a credit for hiring economically disadvantaged youths who are 16 or 17 years of age for any 90-day period between May 1 and September 15. Employees can qualify only one time for this credit with respect to a particular employer, and the credit will be 85 percent up to $3,000 of wages paid.

Cooperative education students will be eligible for certification regardless of whether they are economically disadvantaged, but the credit for the group will be limited to 30 percent of the first $3,000 of wages paid in the first year of employment and 15 percent of the first $3,000 of wages paid in the second year of employment.

Coverage of general assistance recipients under the program will be amended to indicate that recipients of non-cash, as well as cash, assistance will be eligible for certification.

The extension of the jobs credit will take effect on January 1, 1983. The credit for summer youth employment and the change affecting coverage of general assistance recipients takes effect after July 1, 1982, and the change with respect to cooperative education students would be effective after August 31, 1982.

This provision will decrease revenues by $0.2 billion in fiscal year 1983, $0.6 billion in 1984, and $0.9 billion in 1985.

Foreign Corrupt Practices Act

A business expense deduction is allowed for any payment to foreign officials or agents of a foreign government as long as the payment is legal under the Foreign Corrupt Practices Act.

Debt management provisions

The authority given to the Secretary of the Treasury to issue bonds paying interest rates above the statutory ceiling of 4¼ percent is increased by $40 billion, from $70 billion to $110 billion. This change applies to bonds with maturities, when issued, that are longer than 10 years.

The statutory limitations on interest rates payable on savings bonds issued by the Treasury Department is repealed. This action will allow the issuance of savings bonds bearing interest rates related to market-determined rates paid on bonds of comparable character and maturity.

Study of alternative tax systems

The bill instructs the Secretary of the Treasury to conduct a study within 6 months covering the advisability of developing an alternative tax system that would reduce the complexity of the present income tax system and improve the efficiency and equity of the tax system. Alternative tax systems that should be evaluated include a simplified income tax based on gross income, a consumption-based tax structure, and broadening of the current income tax base combined with lowering of current tax rates.

Study of monetary policy

The bill requires that the Administration to prepare a study in which it analyzes the effects on capital markets of a measurement of the growth of debt as the long-term target of monetary policy, and a measurement of total liquid assets as an interim target of monetary policy, instead of measuring the growth of the money supply.

New Jersey general revenue sharing allocation

The New Jersey Franchise and Gross Receipts Tax will be deemed an adjusted tax of units of local government within New Jersey for the entitlement period beginning October 1, 1982. This change will remain in effect for future entitlement periods provided that the State of New Jersey amends the Franchise and Gross Receipts Tax no later than January 1, 1983, to provide for the collection and retention of the tax by units of local government for years beginning January 1, 1983.

Relief for the Jefferson County Mental Health Center

The bill authorizes the payment of $50,000 to the Jefferson County Mental Health Center, Lakewood Colorado, in full settlement of its claims against the United States for repayment of the $74,128 the Center refunded to its employees for individual social security contributions after the Internal Revenue Service erroneously advised the Center that the contributions had been incorrectly withheld.

II. REASONS FOR REVENUE PROVISIONS

The Tax Equity and Fiscal Responsibility Act of 1982 has four principal objectives: to raise revenue as part of an effort to narrow the unacceptably large budget deficits which would result from a continuation of current spending and tax policies, to ensure that all individuals and businesses pay a fair share of the tax burden, to reduce the distortions in economic behavior that result from the present tax system, and to increase the extent to which those responsible for specific Federal Government spending pay the costs of that spending. The committee believes that this bill will make a major contribution to each of these goals.

Revenue needs

Early this year, it became clear that, in the light of the recession, high interest rates and the decline in inflation, continuing present spending and tax policies would result in unacceptably large federal budget deficits. Projections by the Office of Management and Budget and the Congressional Budget Office indicated that federal deficits, if current policy did not change, could reach $182 billion in fiscal year 1983, $216 billion in 1984 and $233 billion in 1985. By 1985, at a time when the economy is expected to be prosperous, the Federal deficit was projected to be 5.6 percent of gross national product—the largest deficit in peacetime history.

Such deficits would have extremely serious consequences. First, a stimulative fiscal policy and the restrictive monetary policy with which the Federal Reserve is attempting to control inflation could lead to continued very high interest rates. These interest rates would reduce business investment, make it difficult for all but the most affluent Americans to acquire their own homes, and cause the bankruptcy of many businesses, both large and small.

Second, large deficits and high interest rates would greatly increase the costs of servicing what would become a crushing burden of the national debt. Outlays for interest on the debt have already grown from $52.5 billion in fiscal year 1980 to an estimated $86.0 billion in 1982, or from 2.0 to 2.8 percent of GNP. The current policy budget projections of OMB and the CBO are that this debt service burden would grow to $147.1 billion in 1985, or to 3.6 percent of GNP. Third, large deficits could put pressure on the Federal Reserve either to pursue very tight monetary policies or to accommodate the deficits with a monetary expansion that could rekindle double-digit inflation. Fiscal restraint would permit the burden of fighting inflation to be spread more evenly throughout the economy.

Third, large deficits would imply a lack of control by Congress over government operations and fiscal policy, which would cause uncertainty among those making financial and investment decisions.

The first congressional budget resolution for fiscal year 1983 contains an integrated set of spending and tax policies designed to bring these defiicits under control. The resolution provides for revenue increases of $20.9 billion in fiscal year 1983, $36.0 billion in 1984 and $41.4 billion in 1985. The committee's bill is consistent with these revenue targets.

It should be noted that these revenue increases are modest in relation to the tax reductions enacted in the Economic Recovery Tax Act of 1981. That bill provided tax reductions, broadly distributed among individuals and businesses, of approximately $88 billion in fiscal year 1983, $140 billion in 1984, and $190 billion in 1985. Thus, the targeted revenue increases provided for in the budget resolution and the committee's bill are only about one-fourth the size of last year's tax cuts.

Tax equity

A widely accepted goal of tax policy is that the tax burden be distributed fairly, in accordance with people's ability to pay. This is particularly important in the United States, where tax collection relies heavily on voluntary compliance. Several studies show that taxpayers are more likely to comply voluntarily with the tax laws if they believe that similarly situated taxpayers are bearing a comparable share of the tax burden.

Unfortunately, over the past several years, the trend has been towards less equity. Dozens of special deductions, exclusions and tax credits have been enacted, and while these generally serve a worthwhile purpose, their cumulative effect is to make the system less equitable and more complex. This bill attempts to reverse this trend by scaling back or repealing those tax preferences which are no longer needed or which can no longer be justified in the light of the present budgetary situation.

The most blatant inequity occurs when some people take advantage of our voluntary compliance system to evade the tax laws. Statistics prepared by the Internal Revenue Service indicate that noncompliance with the tax laws is growing, and it is becoming an extremely serious national problem. It would be grossly unfair to ask the majority of honest Americans to pay more taxes unless every reasonable effort is being made to make sure that tax evaders comply with the law. The cuts in marginal tax rates enacted last year, and the provisions of the committee bill which create a more equitable distribution of the tax burden, will contribute to improved compliance. However, the committee believes that more direct action is needed to deal with this urgent national problem, and the bill contains provisions to improve both the withholding and information reporting systems.

A key goal of the committee was to achieve the revenue targets in the budget resolution through tax changes which improve tax equity, rather than to achieve them through broadly based tax increases, such as increases in marginal individual income tax rates or taxes on energy consumption.

Economic distortions

In recent years, there has been considerable discussion and analysis of the various ways in which the tax system distorts economic behavior in the private sector and the impact of such distortions on economic growth. Much of this discussion has focused on how these distortions might be alleviated by tax reductions; and the 1981 tax reduction was a major step towards this goal. However, it is also possible for economic distortions to result from overly generous tax incentives. The committee has reviewed existing tax incentives with this in mind, and the bill scales back several of those which, in the committee's view, are so generous that they create, rather than reduce, economic distortions.

One example of tax benefits which are overly generous is that the combination of accelerated depreciation and the investment tax credit provides tax benefits which, in many cases, is more generous than deducting the cost of equipment in the year it is placed in service (expensing). Such treatment can encourage businesses to purchase equipment which would not be profitable on a pre-tax basis. The basis adjustment in this bill should reduce the combined benefits of depreciation and the credit to the point that they are approximately equivalent to expensing under conditions presently prevailing in the economy. The present safe-harbor leasing provisions, which are substantially modified in the committee bill, also can lead to incentives to make uneconomic investments.

Other examples of tax incentives which create economic distortions, and which the committee bill repeals or modifies, include the tax treatment of original discount bonds, tax-free dividend reinvestment for public utility stock, industrial development bonds, the tax treatment of mergers and acquisitions, the tax treatment of life insurance, and the completed contract method of accounting. In each of these areas, the committee bill is able both to raise revenues and to improve economic efficiency.

Allocation of the costs of government

A recurring issue for any democratic society is determining the appropriate level of government services. One way to deal with this problem is to raise revenues through user taxes, so that those responsible for government spending pay for that spending and, therefore, do not create an excessive demand for government spending as a result of a disassociation between costs and benefits. For example, 80 percent of Federal retirees age 65 or over receive Medicare, even though they make contributions during only part of their careers; the typical private sector worker makes contributions over his entire career. Thus, the bill subjects Federal employees to the Medicare portion of the social security tax. Similarly, unemployment benefits are supposed to be financed by a payroll tax on employers, but tax revenues have been insufficient so that the unemployment benefit system has had to borrow substantial revenues from the Treasury, that is, from general taxpayers. Therefore, the bill increases both Federal and State unemployment taxes. Likewise, the taxes applying to aviation users are also increased to ensure that users, rather than all taxpayers, pay for a greater share of the expenses of developing the airport and airway control systems. Thirteen percent of the revenue raised by the bill comes from these provisions aimed at those responsible for specific government spending.

III. BUDGET EFFECTS OF THE REVENUE PROVISIONS

The revenue provisions of the committee bill involving statutory changes are estimated to increase net budget receipts by $18.8 billion in fiscal year 1983, $31.8 billion in fiscal year 1984, and $41.5 billion in fiscal year 1985. Together with the additional revenue anticipated from IRS staff increases,[1] the committee bill raises $20.9 billion in 1983, $34.2 billion in 1984, and $43.9 billion in 1985. This achieves the revenue increase target of $98.3 billion for the three fiscal years 1983–1985.

Table 1 is a summary of the estimated revenue effects of the tax provisions of the committee bill for fiscal years 1982–1987 for the major categories of the bill.

Table 2 shows the estimated revenue effects of the specific tax provisions of the committee bill for fiscal years 1982–1987.

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[1] The Administration budget requests additional IRS staff, which it believes will raise revenues by $2.1 billion in fiscal year 1983, $2.4 billion in 1984, and $2.4 billion in 1985. The legislative history of the First Concurrent Resolution on the Budget for Fiscal Year 1983 indicates that the revenue target in that resolution assumed that these staff increases would take place.

Table 1.—Summary of Estimated Revenue Effect of Revenue Provisions Fiscal Years 1982–1987

[Fiscal years, billions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Individual income tax provisions		240	2, 984	3, 261	3, 548	3, 856
Business tax provisions	175	5, 927	12, 755	18, 162	30, 559	42, 262
Compliance provisions		6, 698	7, 056	8, 646	10, 115	11, 112
Pension provisions		211	588	673	762	848
Life insurance and annuities	489	1, 487	1, 510	2, 183	2, 935	3, 167
Employment tax provisions		1, 814	3, 104	3, 869	4, 012	3, 862
Excise tax provisions		2, 509	3, 847	4, 734	4, 873	4, 929
Miscellaneous provisions	−1	−38	−37	−34	−32	−30
Total, tax provisions	**663**	**18, 848**	**31, 807**	**41, 494**	**56, 772**	**70, 006**
Revenue gain resulting from additional IRS enforcement personnel		2, 100	2, 400	2, 400	1, 300	600
Grand total, all provisions	**663**	**20, 948**	**34, 207**	**43, 894**	**58, 702**	**70, 606**

Table 2.—Estimated Revenue Effects of Tax Provisions as Reported by Senate Finance Committee, Fiscal Years 1982–1987

[Millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Individual income tax provisions:						
Alternative minimum tax		(1)	227	262	309	321
10-percent medical deduction floor		342	2, 310	2, 499	2, 690	2, 923
10-percent casualty deduction floor			666	734	800	880
Six-month holding period for capital gains		−102	−219	−234	−251	−268
Total, individual income tax provisions		**240**	**2, 984**	**3, 261**	**3, 548**	**3, 856**
Business tax provisions:						
Reduction in preference items		509	776	779	757	730
Investment tax credit basis adjustment		380	1, 440	2, 757	4, 182	5, 771
Limit investment tax credit to 85 percent of tax liability		152	259	213	178	164
1985–86 ACRS changes				1, 598	10, 173	18, 809
Construction period interest and taxes		568	1, 222	1, 271	1, 158	976

See footnotes at end of table.

Modifications to safe harbor leasing rules	175	1, 145	2, 876	4, 152	5, 729	7, 192
Changes in taxation of foreign oil extraction income		233	504	581	649	708
Limit on possession credit		412	1, 027	1, 251	1, 356	1, 470
Private purpose tax exempt bonds		80	384	789	1, 381	2, 236
Mergers and acquisitions		693	824	745	661	572
Completed contracts		882	2, 235	2, 535	2, 390	2, 559
Accrual accounting for joint ventures of sugar producers		(1)	(1)	(1)	(1)	(1)
Repeal of public utility dividend reinvestment plans		149	416	449	278	----------
Original issue discount and coupon stripping provisions		171	319	473	636	814
Targeted jobs credit		−245	−637	−949	−830	−181
Accelerated corporate tax payments		798	1, 110	1, 518	1, 861	442
Total, business tax provisions	**175**	**5, 927**	**2, 755**	**18, 162**	**30, 559**	**42, 262**
Compliance provisions:						
Withholding of interest and dividends		4, 333	3, 626	4, 066	4, 710	5, 294
Other compliance provisions		2, 365	3, 430	4, 580	5, 405	5, 818
Total, compliance provisions [2]		**6, 698**	**7, 056**	**8, 646**	**10, 115**	**11, 112**
Pension provisions		**211**	**588**	**673**	**762**	**848**

See footnotes at end of table.

Table 2.—Estimated Revenue Effects of Tax Provisions as Reported by Senate Finance Committee, Fiscal Years 1982–1987—Continued

[Millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Life insurance and annuities	489	1, 487	1, 510	2, 183	2, 935	3, 167
Employment tax provisions:						
Independent contractors		−207	−86	86	128	145
FUTA tax		1, 404	2, 353	2, 856	2, 818	2, 554
Federal employees medicare tax [3]		617	837	927	1, 066	1, 163
Total, employment tax provisions		**1, 814**	**3, 104**	**3, 869**	**4, 012**	**3, 862**
Excise tax provisions:						
Airport and airway taxes [4]		813	957	1, 084	1, 210	1, 350
Telephone tax [5]		308	881	1, 600	1, 599	1, 503
Cigarette tax [6]		1, 275	1, 829	1, 859	1, 884	1, 907
Fishing and boating equipment taxes [7]		23	35	37	38	41

See footnotes at end of table.

Repeal of Trans Alaska Pipeline adjustment for crude oil windfall profit tax [8]		90	145	154	142	128
Total, excise tax provisions		**2, 509**	**3, 847**	**4, 734**	**4, 873**	**4, 929**
Miscellaneous provisions:						
National Research Service Awards	−1	−8	−7	−4	−2	(1)
Local newspaper exemption from foundation business holding provisions (Houston)						
Exemption from divestiture requirements of excess holdings of private foundations (El Pomar)						
Foreign Corrupt Practices Act provisions		−30	−30	−30	−30	−30
Settlement of Social Security tax claim by Jefferson County Mental Health Center		(1)				
Total, miscellaneous provisions	−1	−38	−37	−34	−32	−30
Total, tax provisions	**663**	**18, 848**	**31, 807**	**41, 494**	**56, 772**	**70, 006**

See footnotes at end of table.

Table 2.—Estimated Revenue Effects of Tax Provisions as Reported by Senate Finance Committee, Fiscal Years 1982–1987—Continued

[Millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Revenue gain resulting from additional IRS enforcement personnel		2, 100	2, 400	2, 400	1, 300	600
Grand total, all provisions	663	20, 948	34, 207	43, 894	58, 072	70, 606

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[1] Negligible.

[2] Additional gains in budget receipts are expected from the Administration's proposal to increase IRS personnel in taxpayer compliance enforcement activities: $2.1 billion in fiscal year 1983, $2.4 billion in 1984, $2.4 billion in 1985, $1.3 billion in 1986 and $0.6 billion in 1987.

[3] This provision will increase outlays by approximately $25 million in fiscal year 1983, $50 million in 1984, and $75 million in 1985.

[4] The figures represent net increases, after accounting for lower income tax receipts. Additional revenues to the Airport and Airway Trust Fund, resulting from this bill before taking account of the income tax offset are estimated at $1,084 million in 1983, $1,276 million in 1984, $1,445 million in 1985, $1,613 million in 1986, and 1,800 million in 1987.

[5] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $411 million in fiscal year 1983, $1,174 million in 1984, $2,133 million in 1985, $2,132 million in 1986, and $2,004 million in 1987.

[6] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $1,700 million in fiscal year 1983, $2,439 million in 1984, $2,478 million in 1985, $2,512 million in 1986, and $2,542 million in 1987.

[7] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $30 million in fiscal year 1983, $46 million in 1984, $49 million in 1985, $51 million in 1986, and $54 million in 1987.

[8] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $139 million in fiscal year 1983, $260 million in 1984, $285 million in 1985, $267 million in 1986, and $241 million in 1987.

IV. EXPLANATION OF REVENUE PROVISIONS

A. Individual Income Tax Provisions

1. Alternative minimum tax (sec. 201 of the bill and secs. 55–58 of the Code)

Present Law

Add-on minimum tax

Under present law, individuals must pay an add-on minimum tax on certain tax preferences. This tax is in addition to the individual's regular tax. The amount of the minimum tax is 15 percent of the individual's tax preferences in excess of the greater of one-half of the regular income tax paid or $10,000.

The tax preference items included in the minimum tax base are:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Accelerated depreciation on personal property subject to a lease;

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable.);[1] and

(6) Intangible drilling costs on oil, gas and geothermal wells in excess of the amount amortizable with respect to the cost, and in excess of net income from oil, gas and geothermal production.

In computing the amount of the regular tax deduction from the minimum tax base, the regular tax liability is reduced by nonrefundable credits. Credits (other than refundable credits) are not allowed against the individual minimum tax.

Alternative minimum tax

Individuals are also subject to an alternative minimum tax which is payable to the extent it exceeds the individual's regular tax owed.[2] The alternative minimum tax is computed using alternative minimum taxable income, which is the taxpayer's taxable income increased by (1) the deduction for long-term capital gains, and (2) the amount of the taxpayer's adjusted itemized deductions. The tax rate is 10 percent of the alternative minimum taxable income from $20,000 to $60,000 and 20 percent of the amount in excess of $60,000. Tax credits, other than the foreign tax credit, are generally allowable against this tax only if attributable to an active trade or business and only to the extent the tax is not attributable to net capital gains or to adjusted itemized deductions. Any credit disallowed by this rule increases the amount allowed as a credit carryover.

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[1] The rapid amortization of child care facilities terminated for expenditures made after 1981.

[2] A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax and the penalty taxes applicable in certain circumstances for annuities (sec. 72(m)(5)(B)), lump-sum distributions from qualified pension plans (sec. 402(e)) and individual retirement accounts (sec. 408(f) and 409(c))), reduced by all nonrefundable credits including the foreign tax credit (sec. 33).

The foreign tax credit is allowed in full against the alternative minimum tax. In general, the regular foreign tax credit rules apply, but the foreign tax credit limitation is computed separately with respect to the alternative minimum tax. Thus, the amount of foreign tax that may be credited against the alternative tax is limited to the same proportion of the gross alternative tax as the taxpayer's alternative minimum taxable income from sources without the United States bears to his entire alternative minimum taxable income. The taxpayer is then required to pay an amount equal to the greater of the after-credit regular tax or the after-credit alternative minimum tax. A special rule is also provided for computing the amount of unused foreign taxes that may be carried back or carried forward.

Generally, an individual's preference for adjusted itemized deductions is the amount of a taxpayer's itemized deductions (other than the deductions for medical expenses, casualty losses, and state, local and foreign taxes) in excess of 60 percent of adjusted gross income (reduced by the itemized deductions excluded above). In the case of estates and trusts, certain additional adjustments are made.

No estimated tax payments of the minimum taxes are required.

Reasons for Change

The committee has amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. Although these provisions provide incentives for worthy goals, they become counterproductive when individuals are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, the committee has provided an alternative minimum tax which is intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure. The only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which already is limited to a percentage of adjusted gross income.

The committee's changes in the minimum tax also simplify the taxpayer's computations, since the present law add-on minimum tax is repealed. This change actually provides tax reductions for many middle-income taxpayers who pay a minimum tax on some preference income but also have substantial amounts of non-preference income. By adding all preferences into the base of the alternative minimum tax and focusing the minimum tax on high income individuals, the committee's provision increases tax liability only for income classes of taxpayers with over $100,000 of income.

Explanation of Provision

Overview

The bill repeals the present law "add-on" minimum tax for individuals beginning in 1983 and expands the alternative minimum tax.

Generally, the tax base for the alternative minimum tax will be an individual's adjusted gross income plus the taxpayer's tax preferences for the year, reduced by certain deductions. This amount is then reduced by a $30,000 exemption ($40,000 in the case of married taxpayers filing a joint return or a surviving spouse) and is subject to the following minimum tax rates:

Minimum tax base:	*Percent*
$0 to $20,000	10
Over $20,000	20

A married individual filing a separate return will be allowed a $20,000 exemption. The initial $10,000 of the tax base will then be taxed at the 10-percent rate and the remainder at the 20-percent rate.

The amount of minimum tax is the amount by which the tax computed under this rate schedule exceeds the taxpayer's regular tax. Thus, although the tax is, in effect, a true alternative tax, in the sense that it is paid only when the amount of tax computed under the above schedule exceeds regular tax, technically the taxpayer's regular tax continues to be imposed and the amount of alternative minimum tax is the *excess* of the amount computed under the minimum tax rate table over the amount of the regular tax.

The taxpayer may then use the foreign tax credit and the refundable credits to offset this tax.

Minimum taxable income

The amount of income subject to the alternative minimum tax generally is the taxpayer's adjusted gross income (without regard to the net operating loss deduction) reduced by specified itemized deductions and by a deduction for alternative tax net operating losses, and increased by the amount of tax preferences. This net amount of alternative minimum taxable income, reduced by the exemption, is subject to the alternative minimum tax rates described above. Thus, disregarding any net operating losses carried over from other years (for which special rules are provided), a taxpayer can compute minimum taxable income by adding to his or her adjusted gross income (including a negative amount where the taxpayer's "above-the-line" deductions exceed gross income) the amount of preferences for the taxable year and then subtracting certain itemized deductions.

Preferences

In general, the preferences for purposes of the alternative minimum tax are the same as the preferences under present law for the add-on minimum tax. Also, the preference for capital gains remains subject to the alternative minimum tax, but the adjusted itemized deductions preference is repealed.[1]

In addition, the bill adds several new minimum tax preferences for individuals. Certain expenditures which the taxpayer expenses, in excess of the amount which would have been allowable for the taxable year if the expenditures had been capitalized and amortized on a straight-line basis over a 120-month period (beginning with the month in which the expenditures are incurred), are made items of tax preference. These include expenditures for mining exploration costs (under sec. 617), development expenditures (under sec. 616), circulation expenditures (under sec. 173), and research and experimental expenditures (under sec. 174). Interest on obligations issued after 1982, exempt from tax under the Code or other provisions of law, interest excluded under the all-savers and net interest exclusions (sec. 128) and dividends excluded under the dividend exclusion (sec. 116), are also items of tax preference. The amount of tax-exempt income included in alternative minimum taxable income as a preference should be computed as if the rules provided by section 236 of this bill for the treatment of original issue discount applied to tax-exempt obligations.

Minimum tax deductions

In computing the minimum tax base, certain itemized deductions allowable under the regular tax will be allowed. These include the deduction for medical expenses (sec. 213), casualty losses (sec. 165(c)(3)), charitable contributions (sec. 170), the estate tax (sec. 691(c)), housing interest, and other interest to the extent of net investment income included in the minimum tax base. Housing interest includes interest on debt incurred in acquiring, constructing, or substantially rehabilitating a dwelling which is used by the taxpayer or a member of his family and which is a house, apartment, condominium, mobile home not used on a transient basis, or which is the taxpayer's principal residence. Housing interest also includes interest on debt incurred before July 1, 1982, which is secured by a dwelling unit of the type listed above or by a principal residence, regardless of the purpose for which the debt is incurred.

The amount of other interest which is deductible includes interest used to purchase or carry obligations the interest on which is otherwise excluded from tax but which are included in alternative minimum taxable income. However, the interest deduction is limited to net investment income included in the minimum tax base. For this purpose, exempt or excluded investment interest or dividend income, as well as all net capital gain from the sale of investment property will be treated as investment income. Deductions not allowed in computing the minimum tax base will not be taken into account in computing net investment income, but any "above-the-line" investment interest deduction will reduce the amount of net investment income.

Credits

A taxpayer paying the alternative minimum tax is not to obtain the benefit of nonrefundable credits other than the foreign tax credit which is allowed to the extent of the foreign tax on taxpayer's foreign-source alternative minimum taxable income. However, as under present law, the bill provides that credit carryovers to future years from a year in which the taxpayer is liable for some amount of alternative minimum tax are not to be reduced to the extent of the taxpayer's alternative minimum tax liability. For example, if a taxpayer has a regular tax liability before credits of $10,000, investment tax credits of $5,000, and alternative minimum tax before regular tax offset of $8,000, the taxpayer will pay a tax of $8,000 (consisting of regular tax of $5,000 and alternative minimum tax of $3,000). In this case the taxpayer has used up all $5,000 of investment tax credits against regular tax but has received a benefit only from $2,000 of credits. Thus, if the credit would not otherwise expire,[3] the remaining $3,000 of credit for which no tax reduction was obtained is to be available as an additional carryover to the next year to which the credit would be carried over under the usual rules.

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[1] Certain individuals may elect ACRS treatment plus the investment tax credit for intangible drilling costs under section 206 of the bill.

The foreign tax credit and refundable credits are allowable against the alternative minimum tax in accordance with the rules of present law.

Net operating losses

The provision adopts special rules for net operating losses. For purposes of the alternative minimum tax, net operating loss deductions will be determined by using a separate computation of minimum tax net operating losses and loss carryovers. Generally, this computation will take into account the differences between the regular tax base and the minimum tax base.

The amount of the net operating loss (under sec. 172(c)) for any taxable year, for purposes of the minimum tax, will be computed in the same manner as the regular net operating loss except that the items of tax preference arising in that year are added back to taxable income, and only those itemized deductions (as modified under sec. 172(d)) allowable against the minimum tax base are taken into account. In any year to which a minimum tax net operating loss may be carried, the loss will be "used up" by the alternative minimum taxable income (as modified under sec. 172(b)(2)(A)) in the carryover year (whether or not the taxpayer is subject to the minimum tax that year). A transitional rule allows, for purposes of the minimum tax, all pre-effective date regular tax net operating losses to be carried forward as minimum tax NOLs to the first taxable year for which the new minimum tax applies (and to subsequent years until used up). The pre-effective date losses will continue to be subject to the add-on minimum tax, as under present law (sec. 56(b)).

For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses, of which $10,000 are preference items, the minimum tax net operating loss for the year is $5,000. Thus, in any subsequent (or prior) year a $5,000 net operating loss deduction will be allowed to reduce income subject to the alternative minimum tax.

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[3] Where the amount of credits from which no benefit is obtained involves more than one tax credit, the additional credit allowed as a carryover is first to be allocated to the credit which is taken last under the normal Code rules. Thus, any additional credit is first allocated to the research and experimental credit (to the extent that any credits were used in that year), then to the alcohol fuels credit, the residential energy credit, the targeted jobs credit, the WIN credit (to the extent of carryovers used) and finally to the investment tax credit.

Assume that in year two, the taxpayer has $20,000 of minimum taxable income (without regard to the net operating loss deduction) and $20,000 of preferences. The taxpayer will be allowed to reduce his minimum taxable income to $15,000 by the $5,000 net operating loss deduction. The net operating loss deduction for purposes of the regular tax will not be affected by this computation (i.e., the taxpayer will have a loss carryover of $15,000 from year 1 to be used under the regular tax in subsequent years).

Trusts and estates

The provision also contains certain conforming rules relating to the application of the alternative minimum tax to trusts and estates. As under present law, the tax is computed the same as for a married individual filing a separate return (i.e., a $20,000 exemption and the first $10,000 taxed at 10 percent). A trust or estate is to be allowed (in addition to the deductions allowed to an individual) the charitable deduction under section 642(c), the distribution deductions under sections 651(a) and 661(a), and deductions for costs paid or incurred in connection with the administration of the estate or trust. Also, as under present law, items of tax preference are to be allocated between the trust or estate and the beneficiaries in accordance with regulations, and accumulation distributions are outside the scope of the minimum tax.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

Preferences arising under present law in pre-1983 years and creating net operating loss carryforwards to post-1982 years will continue to be subject to the present add-on minimum tax to the extent presently provided under section 56(b).

Revenue Effect

These changes will increase revenues by less than $50 million in 1983, $227 million in fiscal year 1984, $262 million in 1985, $309 million in 1986 and $321 million in 1987.

2. Revision of deduction for medical expenses (sec. 202 of the bill and sec. 213 of the Code).

Present Law

Individuals who itemize deductions may deduct two categories of medical expenses. First, a deduction of up to $150 is allowed for one-half of health insurance premiums. Second, a deduction is allowed for all other unreimbursed medical expenditures, including health insurance premiums not allowed in the first category, to the extent that these expenses exceed 3 percent of adjusted gross income. Drug and medicine expenditures may be included in the second category only to the extent the total of these expenditures exceeds 1 percent of adjusted gross income.

Reasons for Change

The primary rationale for allowing an itemized deduction for medical expenses is that "extraordinary" medical costs—those in excess of a floor designed to exclude predictable, recurring expenses—reflect an economic hardship, beyond the individual's control, which reduces the ability to pay Federal income tax. In recent years, however, because medical costs have risen faster than incomes and because of the broad coverage of expenses (such as capital expenses and transportation expenses), an increasing number of individuals have claimed deductions for expenses in excess of the floor of 3 percent of adjusted gross income. As a result, a larger number of individuals have, in effect, received partial reimbursement for their medical expenses, thereby creating an incentive for further health care spending and exacerbating the problem of rising medical care expenditures. Further, many of the losses which are small relative to income do not significantly reduce ability to pay taxes, especially since they could have been avoided by the purchase of insurance. Finally, the deduction is complex, since detailed records must be kept and difficult distinctions must be made between expenses for medical treatment (deductible) and expenses for ordinary consumption (nondeductible). For these reasons, the committee has decided to limit the use of the medical expense deduction by raising the floor from 3 to 10 percent of adjusted gross income.

Explanation of Provision

The bill increases the floor under deductible medical expenses from 3 percent to 10 percent of adjusted gross income. As under present law, amounts paid for medicine and drugs will be counted toward the deductible amount only to the extent exceeding one percent of adjusted gross income. Furthermore, the bill retains the separate deduction for one-half (up to $150) of amounts paid for medical insurance premiums.

Effective Date

The provision will be effective for taxable years beginning after December 31, 1982.

Revenue Effect

It is estimated that this provision will increase fiscal year budget receipts by $342 million in 1983, $2,310 million in 1984, $2,499 million in 1985, $2,690 million in 1986, and $2,923 million in 1987.

3. Revision of deduction for personal casualty losses (sec. 202 of the bill and sec. 165(c) of the Code)

Present Law

Individuals who itemize deductions may deduct unreimbursed losses of nonbusiness property resulting from fire, storm, shipwreck, or other casualty, or from theft. For tax purposes, the amount of the loss is considered to be the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis. For any one casualty, the deduction is allowed only to the extent that the amount of the loss exceeds $100.

Reasons for Change

The itemized deduction for personal casualty losses creates significant problems of complexity, recordkeeping, and audit for both individuals and the Internal Revenue Service. Arbitrary lines must be drawn between deductible expenditures for sudden casualty losses and nondeductible expenses for losses caused by gradual deterioration. Taxpayers must be prepared to document and defend estimates of fair market value of lost and damaged property for purposes of the deduction. As a result of this complexity, a very high percentage (about 35 percent, according to Internal Revenue Service estimates) of amounts claimed as deductions are not properly deductible.

In addition, the committee is aware that the casualty loss floor has not been raised from $100 since 1964, despite the inflation of recent years. Furthermore, the committee is concerned with the fact that the deduction offsets a higher percentage of losses for high-bracket than for low-bracket taxpayers, even though the latter are less able to purchase insurance to avoid losses and also are more likely to need assistance in coping with expenses. In addition, the committee believes that the $100 floor is not an appropriate measure to identify extraordinary casualty losses that should be taken into account by the tax system because of their impact on an individual's ability to pay taxes.

In order to minimize the number of users of this complex deduction and the partial reimbursement of losses provided by the tax system, while maintaining the deduction for losses which significantly affect an individual's ability to pay taxes, the committee has decided that it is appropriate to put a percentage-of-adjusted-gross-income floor under the casualty loss deduction similar to the floor under the medical expense deduction. An adjusted gross income floor will be fair to taxpayers of all income levels because it recognizes that the size of a loss that significantly reduces an individual's ability to pay tax varies with his income. A loss of a given size generally has a greater adverse impact on a low-bracket taxpayer than on a higher bracket taxpayer.

Explanation of Provision

The bill provides that the deduction for casualty and theft losses will be allowed only to the extent that the total amount of such losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income. As under present law, a casualty or theft loss will be taken into account only to the extent that the loss exceeds $100 for any occurrence.

Effective Date

The provision will be effective for taxable years beginning after December 31, 1982.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $666 million in 1984, $734 million in 1985, $800 million in 1986, and $880 million in 1987.

4. Decrease in holding period for long-term capital gains (sec. 310 of the bill and sec. 1222 of the Code)

Present Law

Gains or losses on sales or exchanges of capital assets held for more than 12 months are considered long-term capital gains or losses (sec. 1222). For noncorporate taxpayers, only 40 percent of net long-term capital gains are included in taxable income, while 100 percent of net short-term gains are included. However, 100 percent of net short-term losses (up to $3,000) are deductible, while only 50 percent of net long-term losses (up to $3,000) may be deducted.

For corporate taxpayers, net long-term gains are subject to an elective, alternative tax rate of 28 percent, while net short-term gains are taxed at ordinary corporate rates.

Reasons for Change

The differential tax treatment of short-term and long-term transactions creates incentives for investors not to realize short-term gains. Studies of capital asset sales data confirm that investors are "locked-in" to investments because they do not desire to realize short-term gains. This reduces capital market efficiency because investors hold assets longer than they otherwise might in the absence of tax considerations. By reducing the capital gains holding period from 12 to 6 months, the committee believes that the lock-in effect and its adverse impact on capital market efficiency will be reduced. Prior to 1976, the holding period was 6 months.

Explanation of Provision

The holding period for determining whether a gain or loss on the sale or exchange of a capital asset or certain business property is long-term or short-term is reduced from 1 year to 6 months. Thus, property held for more than 6 months will be eligible for long-term capital gain or loss treatment. Also, the bill reinstates the rule which was in effect prior to 1977 which required that, in certain circumstances, timber cut during a taxable year receive capital gain treatment only if held for 6 months prior to that taxable year. Numerous conforming changes are made.

Effective Date

The provision applies to sales or exchanges made after June 30, 1982. (Thus, in the case of an installment sale made prior to July 1, 1982, of a capital asset held more than 6 months, but less than one year, all payments received will continue to be treated as short-term capital gain.)

Revenue Effect

This provision reduces fiscal year receipts by $102 million in 1983, $219 million in 1984, $234 million in 1985, $251 million in 1986, and $268 million in 1987.

B. Provisions Primarily Relating to Business

1. Corporate minimum tax (sec. 206 of the bill and new sec. 291 of the Code)

Present Law

Under present law, corporations must pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in this base of the minimum tax for corporations are:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of that deduction computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) 18/46 of the corporation's net capital gain;[1] and

(6) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable).[2]

In computing the amount of the regular tax deduction from the corporation's minimum tax base, the corporation's regular tax liability is reduced by nonrefundable credits other than the credits relating to ESOPs. Credits (other than refundable credits) are not allowed against the corporate minimum tax.

Reasons for Change

Numerous corporate tax preferences have been enacted over the years in order to stimulate business investment and advance other worthwhile purposes. For several reasons, some of these tax preferences should be scaled back. First, the Federal budget faces large deficits, which will require large reductions in direct Federal spending. In addressing these deficits, tax preferences should also be subject to careful scrutiny. Second, in 1981 Congress enacted the Accelerated Cost Recovery System, which provides very generous incentives for investment in plant and equipment. ACRS makes some corporate tax preferences less necessary. Third, there is increasing concern about the equity of the tax system, and cutting back corporate tax preferences is a valid response to that concern.

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[1] Special rules applicable to capital gains from timber have the effect of reducing the tax rate to 10 percent, increasing the exemption to $30,000, and allowing a regular tax carryover.

[2] The rapid amortization for child care facilities terminated for expenditures made after 1981.

For these reasons, the committee bill contains a 15-percent across-the-board cutback in a series of corporate tax preferences.

Explanation of Provisions

Overview

The bill provides for a 15-percent cutback in certain corporate tax preferences. Generally, the cutback applies to preferences not otherwise dealt with in the bill. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and this provision from unduly reducing the tax benefit from a preference. The changes apply to all corporations other than subchapter S corporations.

Depletion for coal and iron ore

In the case of corporations, the statutory percentage depletion rates (under sec. 613) for iron ore and coal (including lignite) are reduced by 15 percent (i.e., effectively to 12.75 percent for domestic iron ore, 11.9 percent for foreign iron ore, and 8.5 percent for coal). However, only 71.6 percent [1] of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the property will be treated as a corporate tax preference under section 57(a)(8).

Bad debt reserves

The bad debt reserve deduction (under sec. 585 or 593) will be reduced by 15 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience. Only 71.6 percent of the excess of the allowable deduction over what would be allowable based on actual experience will then be treated as an item of tax preference (under sec. 57(a)(7)).

Tax-exempt interest

In the case of a financial institution, 15 percent of the otherwise allowable interest deduction incurred or continued to purchase tax-exempt obligations acquired after 1982 will be disallowed.

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[1] The 71.6 percent figure is what is needed to prevent the combination of the add-on minimum tax and the 15-percent preference cutback from reducing the tax benefit from the taxpayer's marginal dollar of preference by more than it is currently cut back by the minimum tax for a taxpayer who has a 46-percent marginal regular tax rate and paid more than $10,000 of regular tax.

Consider, for example, a taxpayer with $100 of percentage depletion. He receives a regular tax benefit of $46 from the preference. However, the preference leads to a direct minimum tax penalty of $15 (the 15-percent minimum tax rate times the $100 preference), as well as an indirect minimum tax penalty of $6.90 through the reduction in the deduction for regular taxes under the minimum tax ($46 times 15 percent). Thus, the net tax benefit from the preference, at the margin, is $24.10.

Under the committee's preference cutback, the depletion deduction is reduced to $85, reducing its regular tax benefit to $39.10 (46 percent times $85). Including only 71.6 percent of the preference ($60.86) in the minimum tax reduces the direct minimum tax to $9.13 (15 percent times $60.86). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent times $39.10, or $5,87), this reduces the total tax benefit from the preference to $24.10 ($39.10 minus $9.13 minus $5.87). Thus, the tax benefit from this taxpayer's marginal dollar of percentage depletion will be the same as under present law.

The interest allocable to tax-exempt obligations shall be determined, except as otherwise provided in regulations prescribed by the Treasury Department, by allocating the taxpayer's otherwise allowable interest deduction to post-1982 tax-exempt obligations by comparing the adjusted basis of those obligations to the adjusted basis of all the taxpayer's assets. For this purpose, calculations of adjusted basis shall be made by averaging adjusted bases of obligations and assets over the course of the taxable year.

DISC

The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder (under sec. 995(b)(1)(F)(i)) is increased by 15 percent, to 57½ percent of certain taxable income. This change has the effect of reducing the tax benefit from DISC by 15 percent.

Section 1250 property

The amount treated as ordinary income on the sale of section 1250 property (real estate) by a corporation will be increased by 15 percent of the additional amount which would be ordinary income if the property were subject to recapture under section 1245 (the rule applicable to personal property). The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under section 1245 will be reduced by 28.4 percent (i.e., will equal 71.6 percent of $^{18}/_{46}$ of the gain, or approximately 28 percent of the gain).

Pollution control facilities

Fifteen percent of the basis of pollution control facilities to which an election under section 169 applies shall be treated as if the election did not apply. The usual rules of ACRS will apply to that portion of the facility (without the 15-percent cutback in the benefit from section 1250 when the property is sold). The minimum tax preference for the remaining property for which 5-year amortization is elected will be reduced by 28.4 percent.

Intangible drilling costs

In the case of an integrated oil company, 15 percent of the amount otherwise allowable as a deduction for intangible drilling costs under section 263(c) will be capitalized to the oil, gas or geothermal property and treated as if it were recovery property assigned to the 5-year class. ACRS deductions and the investment tax credit will be available beginning in the year the property is placed in service. However, it will not be eligible for safe-harbor leasing. If the property is disposed of, the deductions will be subject to recapture (under sec. 1254) and the credit will be subject to recapture under sec. 47 in accordance with the usual recapture rules.

The new 15-percent cutback rules will apply only to otherwise expensed IDCs. Integrated oil companies may elect on an annual basis to capitalize up to 100 percent of otherwise allowable IDCs under these new rules. This election to capitalize part or all of IDCs will also be made available to individual taxpayers with respect to interests in which they are not limited partners. In the case of a partnership, each partner (other than limited partners) may elect separately the portion of IDCs to be capitalized and treated under the new rules. Amounts capitalized and expensed under the ACRS schedule will not be an item of tax preference.

Integrated oil producers are defined as persons who are not independent producers for purposes of the special windfall profit tax rates.

Mineral exploration and development costs

Fifteen percent of the deductions otherwise allowable under section 616 and 617 to a corporation are to be capitalized and treated in generally the same manner as the capitalized IDC's described above. The disposition of property for which exploration costs have been capitalized and amortized may lead to recapture of those costs. Investment credits will be recaptured under the general rules.

Effective Dates

The provisions generally will apply to taxable years beginning after December 31, 1982. However, the provision relating to deductions under secs. 263(c), 616, and 617 will apply to expenditures made after that date; the provision relating to pollution control facilities will apply to property placed in service after that date; and the provision relating to section 1250 property will apply to dispositions after that date.

Revenue Effect

The revenue gain is expected to be $509 million in fiscal year 1983, $776 million in 1984, $779 million in 1985, $759 million in 1986, and $730 million in 1987.

2. Basis adjustment for investment tax credits (sec. 207 of the bill and sec. 48 and new sec. 196 of the Code)

Present Law

In general, a taxpayer is allowed cost recovery deductions for 100 percent of the cost (or basis) of a depreciable asset, including property for which there is allowed a regular or energy investment tax credit, or the 25-percent investment credit for rehabilitation expenditures for certified historic structures.

However, if the 15- or 20-percent investment credit is claimed for qualified rehabilitation expenditures on a nonresidential building, the basis of the property must be reduced by the amount of credit earned. The lower basis is used to compute cost recovery deductions and capital gain or loss.

When the investment tax credit was enacted in the Revenue Act of 1962, the basis of the asset was reduced by the full amount of the credit earned—then 7 percent. The basis adjustment was repealed in the Revenue Act of 1964.

Reasons for Change

Cost recovery deductions for most personal property allowed currently under ACRS in combination with the regular investment tax credit generate tax benefits which have a present value that is more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made; i.e., more generous than the tax benefits of expensing. As a result, investments that would not be undertaken in the absence of an income tax become worthwhile because of the excess tax benefits they generate. The allocation of scarce capital resources is distorted, and economic efficiency is reduced.

This incentive for uneconomic investments can be shown with a simple example. Consider a hypothetical system in which taxpayers can claim a deduction for 120 percent of the cost of an asset and there is a 50-percent tax rate. A taxpayer purchases an asset for $100 which earns only $98 in the subsequent year, after which it is scrapped. This investment would clearly be unprofitable in a tax-free world because the $98 return would not be enough even to recoup the $100 paid for the asset, much less any return on the investment. However, in this hypothetical tax system, the $60 tax benefit that the taxpayer receives from the $120 tax deduction reduces his net cost of the asset to $40. Thus, the $49 after-tax cash flow in year two is enough to yield a 22.5 percent return after taxes on the investment—enough to make the investment attractive to the taxpayer. This incentive for uneconomic investment would be eliminated if the taxpayer were allowed to expense his $100 investment in the year he made the investment.

In evaluating alternative ways to correct this distortion, the committee concluded that a basis adjustment for one-half of the amount of the regular investment credit allowed would make the combination of ACRS cost recovery deductions and the regular investment credit equivalent to expensing at a 10-percent after-tax discount rate. These benefits would provide investment incentives comparable to those in a system without an income tax, and thus would encourage the private sector to undertake the maximum amount of productive investment.

Explanation of Provision

Taxpayers will reduce the basis of assets by one-half of the amount of the regular and energy investment credits and the credit for qualified rehabilitation expenditures for certified historic structures. They will continue to reduce their basis by the amount of the full credit in the case of other rehabilitation expenditures.

The lower basis will be used to compute cost recovery deductions and gain or loss when the asset is sold. If a credit is recaptured, there will be an upward basis adjustment immediately prior to the disposition of the property. A deduction will be allowed equal to the amount of the basis adjustment in the event a credit for which a basis adjustment has been made expires at the end of the 15-year carryover period.

For purposes of determining the amount of ordinary income recaptured under section 1245, the amount of the basis adjustment will be treated as a recovery deduction.

For purposes of computing earnings and profits, cost recovery deductions will not take the basis adjustment into account.

Effective Date

The requirement for this reduction in basis will be effective for property placed in service after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $380 million in fiscal year 1983, $1,440 million in 1984, $2,757 million in 1985, $4,182 million in 1986, and $5,771 million in 1987.

3. Limitation on investment tax credit (sec. 207 of the bill and sec. 46 of the Code)

Present Law

The investment tax credit earned by a taxpayer can be used to reduce tax liability up to certain limits. The limit for taxable years ending after 1981 is $25,000 plus 90 percent of the tax liability in excess of $25,000 (increased from 80 percent in 1981). Unused credits for a taxable year may be carried back to each of the 3 taxable years preceding the unused credit year and then carried forward to each of the 15 following taxable years.

Reasons for Change

The 90-percent limit on the amount of tax which a taxpayer may offset with the investment credit enables corporations to reduce their tax liability to very low percentages of their taxable income and even lowed percentages of their 'book" income as reported to shareholders on financial statements. This reduces confidence in the equity of the tax system.

Explanation of Provisions

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the investment tax credit will be reduced from 90 percent to 85 percent.

Effective Date

The amendment made by this provision will apply to taxable years that begin after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $152 million in fiscal year 1983, $259 million in 1984, $213 million in 1985, $178 million in 1986 and $164 million in 1987.

4. Accelerated Cost Recovery System (ACRS) changes for 1985 and 1986 (sec. 208 of the bill and sec. 168 of the Code)

Present Law

Overview

The Economic Recovery Tax Act of 1981 (ERTA) replaced the prior law depreciation system with the Accelerated Cost Recovery System (ACRS). ACRS is a system for recovery of capital costs using accelerated methods over predetermined recovery periods that are generally shorter than prior law useful lives. The ACRS methods of cost recovery and recovery periods are the same for both new and used property. Recovery of costs generally is determined by using a statutory accelerated method. As an option, the taxpayer may choose to recover costs using the straight-line method over either the regular recovery period or one of the longer recovery periods provided.

Accelerated methods of cost recovery for personal property

In general, the recovery deduction for personal property in each year of the recovery period is determined by applying a statutory percentage to the unadjusted basis of the property. In determining the annual deduction, the applicable percentage to be applied to the unadjusted basis of the property depends on the property's class and the number of years since the property was placed in service by the taxpayer. The recovery deduction for the taxable year in which property is placed in service is based on the full recovery percentage prescribed in the statutory table for the first recovery year, regardless of when the property was placed in service during the taxable year. No recovery deduction is allowable in the year of an asset's disposition.

Three statutory schedules of accelerated recovery percentages are provided for each class of recovery property. One schedule applies to recovery property placed in service in the years 1981 through 1984. One schedule applies to recovery property placed in service in 1985. The third schedule for each class applies to recovery property placed in service after 1985.

The schedules for personal property placed in service in 1981 through 1984 were developed to approximate the benefits of using the 150-percent declining balance method for the early recovery years and the straight-line method for the later recovery years. The schedules for personal property placed in service in 1985 were developed to approximate the use of the 175-percent declining balance method for the early recovery years and the sum-of-the-years-digits method for the later recovery years. The schedules for personal property placed in service after 1985 were developed to approximate the use of the 200-percent declining balance method for the early recovery years and the sum-of-the-years-digits method for the later recovery years. All of the schedules reflect the allowance of only a half-year of depreciation for the first recovery year and the allowance of the remaining recovery deductions over the remaining recovery years.

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Reasons for Change

As explained in the discussion of the basis adjustment (item 2, above), there are strong economic reasons why the combined effect of the investment credit and accelerated depreciation should not be more generous than expensing. Repeal of the scheduled accelerations of depreciation is needed to accomplish the committee's goal of establishing a system approximately equivalent to expensing for assets in the 3- and 5-year ACRS classes.

Also, the acceleration of cost recovery deductions after 1984 may encourage taxpayers to delay making investments until after that date. Repealing the acceleration now will eliminate that incentive.

Explanation of Provision

The committee bill repeals the provisions of ACRS that would have accelerated cost recovery rates for personal property to rates approximating the benefits of using a 175-percent declining balance method in 1985 and the 200-percent declining balance method after 1985.

Effective Date

The provisions will apply for taxable years ending after date of enactment.

Revenue Effect

The revenue gain is expected to be $1,598 million in fiscal year 1985, $10,173 million in 1986, and $18,809 million in 1987.

5. Construction period interest and taxes (sec. — of the bill and new sec. 189A of the Code)

Present Law

Under section 189, individuals, personal holding companies, and subchapter S corporations are required to capitalize interest and real property taxes attributable to the construction period of real property (other than low-income housing) to be used in a trade or business or held for investment. The capitalized interest and taxes are amortized (i.e., deducted in equal portions) over certain periods, generally 10 years. The interest that must be capitalized is interest which is attributable to the construction period on any debt incurred or continued for the purpose of acquiring, constructing, or carrying real property other than low income housing. The construction period is defined as the period beginning on the date construction of the building or improvement begins and ending on the date the property is ready to be placed in service or is ready to be held for sale.

The amortization of capitalized interest and taxes begins in the year the interest or taxes was paid or accrued. However, the amortization of capitalized interest and taxes is then suspended until the year the building or improvement is ready to be placed in service or to be sold, and amortization resumes at that time.

Corporations, other than personal holding companies and subchapter S corporations, are not subject to the capitalization requirement of section 189. For these corporations, amounts paid or accrued for interest and real property taxes are allowed as deductions for the year in which paid or accrued. Certain prepaid interest, however, must be capitalized and deducted in the years to which properly applicable. In addition, under section 266, taxpayers may capitalize certain taxes and interest attributable to both real and personal property and include the capitalized items in the basis of the property.

Reasons for Change

The allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or accrued because it is necessary to produce income and is usually consumed in the process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, under the matching concept, these expenditures should be treated as a future expense when the income "resulting" from the expenditure is received.

In the case of a taxpayer who constructs a building and subsequently receives income in the form of rents from that building, the accounting concept of matching income against expenses should require that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and subsequently deducted as depreciation expenses. Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.

The committee believes that construction period interest and taxes, as other costs of construction such as labor and materials, generally should be capitalized and deducted only when the buildings are sold or are used to produce income. In the case of real property other than low-income housing, these rules have applied to individuals, subchapter S corporations, and personal holding companies since section 189 was added to the Code in the Tax Reform Act of 1976.

Corporations other than personal holding companies and subchapter S corporations are not now required to capitalize construction period interest and taxes. The ability to currently deduct construction period interest and taxes permits the deferral of tax on current income, which is the equivalent of an interest-free loan from the government that can be a significant economic benefit. The committee believes that this situation is not compatible with the general objective of matching income and expenses. The committee, therefore, has decided that corporations should be required to capitalize construction period interest and taxes. However, the committee also believes, that, in view of the present depressed state of the housing industry, it is appropriate to limit this requirement to nonresidential construction.

Explanation of Provision

Section 189 would be extended to require corporations (other than subchapter S corporations and personal holding companies) to capitalize construction period interest and taxes for nonresidential real property. The definition of the construction period to corporations will be the same as under present section 189. Construction period interest and taxes for nonresidential real property are real property taxes for nonresidential real property and interest paid or accrued on debt incurred or continued to acquire, construct, or carry nonresidential real property, but only to the extent such taxes and interest are attributable to the construction period for such property. The bill requires the Treasury Department to issue regulations allocating interest to expenditures for real property during construction. The committee expects that these regulations will adopt rules similar to those used for financial accounting purposes. This rule applies only to taxes and interest that would, but for this rule, be allowable as a deduction for the taxable year in which paid or accrued. As under section 189, capitalized construction period interest and taxes will be amortized over a 10-year period. One-tenth of capitalized interest and taxes will be deductible for the year in which they were paid or accrued in. The other nine-tenths will be deductible over a nine-year period beginning with the year in which the property is ready to be held for sale or ready to be placed in service.

Effective Date

The bill would apply to interest and taxes paid or incurred in taxable years beginning after December 31, 1982, on nonresidential real property the construction of which begins after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $568 million in fiscal year 1983, $1,222 million in 1984, $1,271 million in 1985, $1,158 million in 1986, and $976 million in 1987.

6. Modifications to leasing rules (secs. 211, 212, and 213 of the bill and sec. 168 of the Code)

Present Law

Overview

Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the law contained rules to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery (depreciation) deductions and investment tax credits. The prior rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owned the property for tax purposes. These rules generally were not written in the Internal Revenue Code; instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law was that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have nontax economic substance. The specific prior law rules are discussed below.

ERTA provides a new set of rules which represent a major departure from prior law. These new provisions are intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under the new rules, certain transactions involving tangible personal property are treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction meets these safe harbor requirements, the lessor in the agreement is treated as the property owner for Federal income tax purposes and is entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who has acquired and will use the property can, in effect, sell some of the tax benefits associated with the property to a corporation, while retaining all other economic benefits and burdens of ownership. The prior law rules remain in effect for transactions not qualifying for the safe harbor or when the safe harbor is not elected.

Pre-ERTA leasing rules

Underlying principles

In general, the determination of lease treatment under pre-ERTA law required a case-by-case analysis based on all facts and circumstances. Although the determination of whether a transaction was a lease was inherently factual, a series of general principles was embodied in court cases, revenue rulings, and revenue procedures. Those principles are still used in determining the character of transactions that are not eligible for the new safe-harbor rules or for which the safe-harbor election is not made.

For a transaction to be a lease under prior law, the lessee could not hold title to or have an equity interest in the property. However, the fact that the lessor had title did not guarantee that the lessor was the tax owner. Both the courts and the IRS looked to additional criteria in determining whether a transaction was a lease. These criteria focused on the substance of the transaction rather than its form. The courts did not disregard the form of a transaction simply because tax considerations were a significant motive so long as the transaction also had a bona fide business purpose and the lessor retained sufficient burdens and benefits of ownership.[1]

To be entitled to depreciation deductions as the owner of the property, the lessor had to show that the property is being used for a business or other income-producing purpose. To have had a business purpose, the person claiming ownership (i.e., the lessor) at least had to have a reasonable expectation that he would derive a profit from the transaction independent of tax benefits.[2] This requirement precluded lease treatment for a transaction intended merely to reduce the user's costs by utilizing the lessor's tax base. For a sale-leaseback, other nontax business motives were considered in determining the substance of the transaction.

The fact that the lessor in a lease financing transaction could show a profit or business purpose, however, did not automatically result in lease treatment under prior law rules, since a profit or business motive could also exist in a financing arrangement. In addition, the lessor had to retain meaningful benefits and burdens of ownership.[3] Thus, lease treatment was denied under prior law rules if the user had the option to obtain title to the property at the end of the lease for a price that either was nominal in relation to the value of the property at the time when the option could be exercised (as determined at the time the parties entered into the agreement) or which was relatively small when compared with the total payments required to be made.[4]

Where the residual value of the property to the lessor was nominal, the lessor was viewed as having transferred full ownership of the property for the rental fee. Where the purchase option was more than nominal but relatively small in comparison with fair market value, the lessor was viewed as having transferred full ownership because of the likelihood that the lessee would exercise the bargain purchase option.[5] Furthermore, if the lessor could force the lessee to purchase the property at the end of the lease (a "put"), the transaction might also be denied lease treatment under prior law because the put eliminated the risk borne by owners of property that there will be no market for the property at the end of the lease.

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[1] *See, Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976); Rev. Rul. 55–540, 1955–2 C.B. 39 (and cases cited therein); *see generally, Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[2] *See, Hliton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[3] *See, Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976); *Swift Dodge* v. *Commissioner*, 76 T.C. 547 (1981); Rev. Rul. 55–540, 1955–2 C.B. 39 (and cases cited therein).

[4] *See*, Rev. Rul. 55–540, 1955–2 C.B. 39 (and cases cited therein).

[5] *See, M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

Objective guidelines used in structuring transactions

The question of exactly what burdens and benefits of ownership had to be retained by the lessor under prior law rules created some confusion for people trying to structure leases that, at least in part, were motivated by tax considerations. To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines were met and if the facts and circumstances did not indicate a contrary result, the Service issued (and continues to issue) an advance letter ruling under the prior law rules that the transaction was a lease and that the lessor was the owner for Federal tax purposes. The guidelines applied only to leveraged leases of equipment. The general principles described above continued to govern nonleveraged leases and leases of real property. The guidelines were not by their terms a definitive statement of legal principles and were not intended for audit purposes. If all requirements of the guidelines were not met, a letter ruling could still be issued in appropriate cases if, after considering all facts and circumstances, a transaction was a lease under the general principles discussed previously. However, in practice, many taxpayers took into account the guidelines' requirements in structuring transactions. The guidelines may be viewed as a type of safe harbor.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property. This rule represents an attempt to ensure that the lessor must suffer some significant loss if the property declines in value.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, when the property is first placed in service by the lessee, the lessor cannot have a contractual right to require the lessee or any other party to purchase the property, even at fair market value (a put).

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bears the risk implicit in ownership that no market will exist at the end of the lease. The owner of depreciable property is the person who bears any decline in value of the asset. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test (described below). However, several courts have held that the mere existence of a fixed price purchase option does not prevent lease treatment so long as the lessor retains other significant burdens and benefits of ownership.[6] In addition, because Revenue Procedure 75–21 generally is considered a safe harbor, a favorable ruling still could be issued under the general principles discussed above despite the existence of a fixed price purchase option.

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow from the transaction independent of tax benefits. As mentioned previously, a profitability requirement is based on the requirement that lease transactions must have a business purpose independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76–30, 1976–2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could realistically use the property, the lessor has not retained any significant ownership interest.

Recent developments in the case law

There have been several recent decisions by the courts relating to the characterization of transactions as leases under pre-ERTA rules. The first of these cases is the Supreme Court decision in *Frank Lyon* v. *United States*,[7] which deals with a sale-leaseback of real property financed by the lessor with cash and resource debt. In *Frank Lyon*, the Supreme Court held that the transaction was a lease and stated that where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Among the many factors the court cited for its decision was the fact that there was a business purpose for the sale-leaseback, as evidenced by the fact that State and Federal regulations prohibited the lessee-bank from borrowing a sufficient amount to finance construction, that diversification was the lessor's principal motive, and that the depreciation deductions would have been equally available to the lessee-bank had it retained title. The court also held that the lessee's option to purchase, though fixed, was for a reasonable amount, and that the lessor bore the risk that the lessee would not exercise that option if the price was more than the fair market value of the property. The facts in *Frank Lyon* indicated that the lessor would realize an overall profit from the transaction independent of tax benefits if the lessee exercised its option to purchase. In *Hilton* v. *Commissioner*,[8] the court applied the *Frank Lyon*, test in denying lease treatment where the lessor could not reasonably expect to show a profit from the transaction independent of tax benefits.

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[6] *See, e.g., Swift Dodge* v. *Commissioner*, 76 T.C. 547 (1981).

[7] 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976).

Another important decision dealing with prior law lease rules is *Swift Dodge* v. *Commissioner*[9] In *Swift Dodge*, an automobile dealership operated a separate leasing business. The company acquired most of its cars for lease from amounts borrowed from banks on a recourse basis. The auto dealer-lessor obtained a profit from the leases independent of tax benefits. The lease contained a terminal rental adjustment clause that permitted an upward or downward adjustment of rent to make up for any difference between the projected value of the property at the end of the lease and the actual value of the property upon lease termination.

The court held that these nonleveraged transactions were leases and not conditional sales. It cited the general rule that economic substance prevails over form and cited *Frank Lyon* for its statements regarding the necessity of the lessor retaining significant and genuine attributes of the traditional lessor form. It stated that a transaction is a lease if the lessor assumes burdens other than those of a lender and is subject to significant risk not ordinarily incident to a secured loan.

Safe harbor leasing rules

Overview

The safe-harbor leasing provisions of ERTA are intended to permit owners of property who cannot use the tax benefits of ownership (e.g., depreciation and investment credit) to transfer some of those benefits to persons who can use them without having to meet the prior law requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operate by guaranteeing that for Federal tax purposes qualifying transactions will be treated as leases, and that the nominal lessor will be treated as the owner of the property, even though the lessee is in substance the owner of the property and the transaction otherwise would not be considered a lease.

Eligibility requirements

To qualify for the safe harbor, a transaction must meet the following requirements:

1. All parties to the agreement must elect to have the transaction treated as a lease;
2. The nominal lessor must be (a) a corporation (other than a a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which are one of the corporations described in (a), or (c) a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations;

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[8] 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[9] 76 T.C. 547 (1981).

3. The lessor must have a minimum at-risk investment in the property at all times during the lease term of at least ten percent of the adjusted basis of the property; [10]

4. The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and

5. The property must be "qualified leased property."

Qualified leased property

In general, qualified leased property means new equipment eligible for both ACRS and the investment credit. The equipment may be leased within 3 months after the property is placed in service without violating the requirement that the equipment be new equipment (called the 90-day window). Property used by a tax-exempt organization or a U.S. Federal, State, or local governmental unit generally is ineligible. However, under a special exception, qualified mass commuting vehicles financed in whole or in part by tax-exempt bonds are eligible even though the property is used by a tax-exempt organization or governmental unit. For mass commuting vehicles, the lessor is eligible for ACRS deductions but not the investment credit.

Factors disregarded

If a transaction meets the safe-harbor requirements, the transaction will be treated as a lease entered into by the parties to the agreement, and the nominal lessor will be treated as the owner for Federal tax purposes. Thus, the nominal lessor will be entitled to the associated cost recovery allowances and investment credit. The following factors, therefore, will not be taken into account in determining whether a transaction is a lease, as they had been under prior law:

1. The fact the lessor or lessee must take the tax benefits into account in order to realize a profit or cash flow from the transaction;

2. The fact the lessee is the owner of the property for State or local law purposes (e.g., has title to the property and retains the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);

3. The fact that no person other than the lessee may be able to use the property after the lease term;

4. The fact the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment is made upward or downward to reflect the difference between the expected residual value of the property and the actual sales price; and

5. The fact the lessee, or a related party, has provided financing or has guaranteed financing for the transaction (other than the lessor's minimum 10 percent investment).

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[10] This safe-harbor rule differs from the corresponding prior law rule in two respects. First, the minimum investment is reduced from 20 percent to 10 percent under the safe harbor. Second, the minimum investment does not have to be maintained at the same level throughout the lease term since the test is applied with reference to adjusted basis (original basis reduced by depreciation deductions).

Amount and timing of deductions and credits

The legislative history of the safe-harbor provisions suggests that a lessor's basis in the leased property includes the entire amount of any obligation with respect to the property even if the obligation of the lessor is contingent or offset by rental payments. This rule, which overrides prior case law, eliminates the need for the parties to actually make the offsetting payments to ensure the tax consequences of basis, income, and deductions that would have occurred if the payments had been made. However, the lessor must report as income all rental payments due, even if not actually received because of the offset agreement.

In addition, the legislative history suggests that the lessor must report the rental income on a ratable basis, eliminating the deferral of income to the lessor that would result by virtue of, for example, a balloon payment agreement. With respect to interest deductions, calculations under a level payment mortgage assumption are permitted.

Description of safe-harbor transactions

The safe-harbor rules have been used to guarantee lease treatment for several types of transactions. Most of these transactions fall into two categories. The transactions in the first category are often referred to by practitioners as tax benefit transfers because their only purpose is the transfer of tax benefits. (Another name used is wash sale-leasebacks.) Although the safe harbor has been used primarily for this purpose, it has also been used to guarantee lease treatment for lease financings, which involve nontax business considerations.

Tax benefit transfers

Treasury regulations contemplate that those who use the safe-harbor leasing rules for tax benefit transfers will structure their transactions as a particular kind of sale and leaseback. This type of transaction involves three steps. First, the seller/lessee (who may be either an individual or a corporation) acquires the property with its own funds or borrowed funds and then, within three months, transfers it in a nominal "sale" to the buyer/lessor. In exchange, the seller/lessee receives cash for a part of the selling price and a level payment nonrecourse note for the balance. The seller/lessee continues to use the property and typically enjoys all the economic benefits and burdens of ownership. In the standard transaction, the user of the property retains all incidents of State law ownership. For Federal income tax purposes, however, the buyer/lessor may claim the cost recovery deductions and investment credits allowable for the property. The second step is that the seller/lessee nominally leases the property back from the buyer/lessor. The lease rental payments to the buyer/lessor are structured so as to equal exactly the debt service payments to the seller/lessee arising from the nonrecourse note in stage one. Thus, no cash changes hands during this second stage. However, because the debt service payment consists of both interest and principal, the excess of lease rent over interest for any taxable year (which equals the principal repaid in the year) is treated for Federal income tax purposes as income to the buyer/lessor and as a deduction for the seller/lessee. Third, at the end of the lease, the seller/lessee nominally repurchases the property for a token amount, such as $1.

The substantive effect of this sale-leaseback transaction is that the buyer/lessor has purchased a stream of tax benefits from the seller/lessee for an amount equal to the cash paid for the property during the first stage of the transaction. (This is the only cash which changes hands, apart from the nominal amount paid for repurchase of the property in stage three.) The stream of tax benefits purchased by the buyer/lessor equals the ACRS cost recovery deductions, plus the investment tax credit (including the energy credit if applicable), minus the net rental income arising from the lease (the excess of lease rentals over interest on the nonrecourse note, which precisely equals the principal payments on the note).[11]

Lease financing

In addition to tax benefit transfers, the safe-harbor leasing provisions have been used to guarantee lease treatment for lease financing transactions that fail to meet all of the requirements of the guidelines. Often, the requirement of the guidelines that these lessors and lessees want to avoid is the prohibition on options for the lessee to purchase the property at a fixed price determined at the time of the agreement. The safe harbor has also been used to guarantee lease treatment for lease financings that involve terminal rental adjustment clauses.

Also, the 90-day window in the safe-harbor rules encourages businesses to use the safe harbor because they need not finalize their lease by the exact date on which the property is put in service. Under prior law, if a sale and leaseback was entered into after the property was placed in service, the property could be characterized as used property and subjected to the limits on the investment credit for used property.

Recapture rules

If the lessee acquires the property from the lessor at the end of the lease and subsequently disposes of it, the lessee will be subject to the recapture rules under sections 47 and 1245 as if the lessee had been considered the owner of the property for the entire term of the lease, except that any amount recaptured by the lessor will not be recaptured again by the lessee. For example, assume the lessor claimed $100 of cost recovery allowances for 5-year recovery property over the lease term and has a zero adjusted basis in the property at the end of the lease. The lessor sells the property to the lessee for $1.00. The lessee subsequently sells the property to a third party for $80. The lessor would have a $1 gain on the sale to the lessee, all of which would be treated as ordinary income under the section 1245 recapture rules. The lessee would have $79 gain ($80 sales price – $1 cost basis) all of which would be treated as ordinary income under the section 1245 recapture rules.

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[11] As an alternative to this type of transaction, in which the user holds State law title to the property, a tax benefit transfer may be structured in the following manner: First, a bank or other financing party acquires the property and leases the property to the user in a transaction that meets the requirements for lease treatment under Rev. Proc. 75-21. Second, the lessor does a safe-harbor sale and leaseback to transfer the tax benefits to another party. The distinguishing feature of this type of tax benefit transfer is that the bank or other financing party rather than the user is the actual owner of the property.

Reasons for Change

The committee believes that significant changes are needed to the rules which determine whether a transaction qualifies as a lease for Federal income tax purposes.

The committee is concerned that the present safe-harbor rules have enabled some taxpayers to avoid their equitable share of tax. This includes the use of safe-harbor leasing to increase the benefits not associated with investment in machinery and equipment (like percentage depletion), to avoid payment of any tax and to generate tax refunds. The committee is also concerned with the derivative effects of such practices in eroding respect for and compliance with the tax laws on the part of other taxpayers. Therefore, the committee bill restructures the rules relating to safe-harbor leasing to ensure that it cannot be used to produce these unfair results.

The committee also believes that the present rules result in an excessive revenue loss. This is not appropriate at a time when many direct spending programs are being reexamined to see if they are too wasteful. Thus, the committee bill contains provisions which are intended to reduce the revenue loss of safe-harbor leasing.

Finally, the committee believes that provisions as controversial as the safe-harbor leasing provisions should be re-examined by Congress. To ensure that this occurs, the committee decided to sunset the safe-harbor leasing provisions after fiscal year 1985.

Explanation of Provisions

a. Overview

Pre-ERTA leasing.—The committee bill modifies the pre-ERTA rules governing lease treatment by permitting fixed price purchase options for leases entered into after December 31, 1984. In addition, the committee bill prevents the Internal Revenue Service from denying lease treatment for certain motor vehicle operating leases containing terminal rental adjustment clauses until either the Internal Revenue Service issues prospective rules or Congress enacts legislation specifically addressing the legal consequences of those clauses. These changes apply only to those transactions for which an election under the safe-harbor lease rules is not in effect.

Safe-harbor leasing.—The committee bill substantially modifies the ERTA safe-harbor leasing provisions. In general, the committee bill limits the ACRS and interest deductions and the investment credits that may be claimed by the lessor, limits the amount of the lessee's property that may be leased, limits the extent to which the lessor may reduce its tax liability through safe-harbor leasing, and limits the length of the lease term. Public utility property is made ineligible for the safe-harbor provision. Certain tax-exempt organizations will not be allowed to structure transactions to use safe-harbor leasing. Investment tax credit (ITC) strips are allowed for transactions entered into before October 20, 1981.

The committee bill also restricts the ability of taxpayers to increase percentage depletion and foreign tax credits by virtue of safe-harbor leasing. The bill also prohibits safe-harbor leasing among related parties.

Leases of mass commuting vehicles generally are not subject to these changes if the property is purchased pursuant to certain binding contracts or commitments entered into on or before March 31, 1983, and the property is placed in service before January 17, 1988.

The provisions of the committee bill generally apply to leases entered into or property placed in service after July 1, 1982. However, the provisions restricting the ability of taxpayers to increase percentage depletion by virtue of leasing and the provisions excluding related party transactions apply to leases entered into after February 19, 1982. The committee bill also contains transitional rules. The safe-harbor leasing provisions will be repealed for property placed in service after September 30, 1985.

b. Changes to pre-ERTA leasing rules

Fixed price purchase options

Under the committee bill, for leases entered into after December 31, 1984, fixed price purchase options are not to be taken into account in determining whether a transaction is a lease under the pre-ERTA rules. To qualify, the option must be at least 10 percent of the original cost of the property. As under present law, the fact the lessor has a contractual right requiring the lessee to purchase the property (i.e., a put option) in a leveraged lease must be taken into account in determining whether a transaction is a lease under pre-ERTA rules.

Terminal rental adjustment clauses

The committee bill will prevent the IRS from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses that require or permit the rental price to be adjusted upward or downward by reference to an amount realized by the lessor upon sale or other disposition of the property. The committee bill does not address the legal effect of these clauses and does not prevent the Treasury from issuing rules on a prospective basis addressing the legal effect of these clauses.

The provisions of the committee bill regarding terminal rental adjustment clauses apply only to operating leases in which the lessee uses the property for business, as opposed to personal purposes. For this purpose, a lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

No effect on other pre-ERTA rules

The committee bill otherwise does not affect the general principles for determining lease treatment under pre-ERTA rules or the requirements of Revenue Procedure 75–21. Thus, as under present law, the lessee may not hold title to or have an equity interest in the property. To be entitled to depreciation deductions, the lessor must show a profit from the transaction independent of tax benefits. In addition, the lessor must retain other meaningful indicia of ownership to establish that the lessor is in substance the owner of the property.

c. Safe harbor leasing rules

Eligibility requirements

Structure of safe-harbor leases

Maximum lease term.—The bill provides that the term of a safe-harbor lease, including any extensions, can be no longer than the present class life of the leased property (that is, the ADR midpoint life of the property as of January 1, 1981). In the case of property for which the present class life is not determined, the maximum safe-harbor lease term is one year longer than the recovery period provided by the bill (as described below) for property subject to a safe-harbor lease.

Maximum interest rate.—In general, the bill provides that the maximum annual interest rate allowed on obligations of the lessor (or a person related to the lessor) to the lessee (or a person related to the lessee) in a safe-harbor sale-leaseback is 5 percentage points less than the interest rate applicable to tax underpayments and overpayments on the date the agreement is executed. However, this maximum interest rate cannot be less than 8 percent. For example, if the rate applicable to underpayments and overpayments of tax were 20 percent at the time of the agreement, the maximum annual interest rate would be 15 percent. This interest rate limitation does not apply to a safe-harbor lease where there is no lessee financing. For purposes of this provision, the definition of a related person is the same as under section 168(e)(4).

Amount and timing of ACRS deductions and investment credit

Under the bill, cost recovery allowances for property subject to a safe-harbor lease are computed using the straight-line method (with a half-year convention and without regard to salvage value) and a recovery period determined in accordance with the following table:

In the case of:	The recovery period is:
3-year property	5 years
5-year property	8 years
10-year property	15 years

An investment tax credit earned on property subject to a safe-harbor lease is allowable over three taxable years in accordance with the following schedule: 50 percent of the credit in the first taxable year, 25 percent of the credit in the second taxable year and 25 percent of the credit in the third taxable year. For example, with respect to leased property in the 3-year recovery class for which a 6-percent regular investment credit is earned, a 3-percent credit is allowable in the first taxable year and a 1½-percent credit is allowable in each of the two succeeding taxable years. For purposes of determining the order in which credits may be used, the portion of the credit earned but not allowable in the first taxable year is treated as an unused credit carried over from the first taxable year. Thus, in the taxable year it is first allowable, this portion is applied against the investment credit tax liability limitation before credits earned for that year.

For purposes of determining basis of the asset, the basis adjustment for half of the full investment tax credit will occur in the first taxable year, without regard to the new rule deferring half the credit to subsequent years.

ITC strip

The committee bill will allow safe-harbor lease treatment for transactions referred to as lease-leasebacks or ITC strips entered into before October 20, 1981, which is the date Treasury issued its temporary regulations dealing with the safe-harbor provisions. An ITC strip is intended to permit the lessee to transfer the investment credit only. The committee bill does not alter the ability of the parties to structure a lease outside of the safe harbor so that the lessee retains the investment credit and the lessor the depreciation deductions (sec. 48(d)).

Qualified leased property

Property used by former tax-exempt organizations

Under the bill, qualified leased property will not include property (other than mass commuting vehicles) leased to a person that was a tax-exempt organization at any time within the 5-year period preceding the date of the lease agreement. This rule also applies where a predecessor of the lessee, within the 5-year period prior to date the lease is entered into was a tax-exempt organization and was engaged in activities substantially similar to the activities in which the lessee is engaged. The Secretary shall have authority to prescribe appropriate rules to carry out the purposes of this provision, including rules governing transactions by related parties.

Public utility property

Public utility property, as defined in section 167(l) (3) (A), is made ineligible for safe-harbor leasing.

Limitations on lessee

Amount of eligible property

The committee bill limits the amount of the lessee's property eligible for the safe harbor. For 1982, the safe harbor will apply with respect to no more than 45 percent of the cost of the lessee's property placed in service during calendar year 1982. Qualified leased property that is not subject to the amendments made by the committee bill by virtue of the July 1, 1982, general effective date rule or the transition rules (as described below) counts toward the lessee cap in 1982, but the rule does not operate to denv safe-harbor lease treatment for leases of that property. For example, if 50 percent of a lessee's property were covered by safe-habor leases that are not subject to the amendments made by the committee bill, those lease would not be affected by the cap but the lessee could not safe harbor lease any more of its property in 1982. If only 25 percent of a lessee's property were not subject to the amendments made by the committee bill, it could safe harbor lease an additional 20 percent of its eligible property during the remainder of 1982. For property placed in service in calendar year

1983, the percentage limitation is also 45 percent. For property placed in service in each of the calendar years 1984 and 1985, the applicable percentage limitation is 40 percent.

For this purpose, the lessee's property includes the cost basis of all qualified leased property leased by the lessee under a lease for which a safe-harbor election has been made and all other new section 38 property of the lessee that is placed in service during the taxable year. A lessee's property includes any property that the lessee is considered owning for Federal tax purposes without regard to the safe-harbor rules. A lessee may not take inconsistent positions by claiming rental deductions with respect to property on the one hand, and, on the other hand, claiming it owns the property for purposes of this safe-harbor limitation.

The Secretary shall prescribe rules for applying this limitation on a consolidated basis for companies filing consolidated returns.

For any year in which this limitation applies, property leased last during the year is the first property to be excluded from the safe-harbor. The exclusions thus occur in reverse chronological order. If the limitation applies to a portion of leased property, the safe harbor will continue to apply to the portion that does not exceed the limitation.

Limitations on ability of lessee to increase other tax benefits

The committee bill limits the extent to which the lessee can use safe-harbor leasing to increase its percentage depletion deductions and foreign tax credits. Under the bill, the lessee must compute its foreign tax credit and both the 50-percent and 65-percent limitations on percentage depletion deductions based on taxable income without regard to the safe-harbor lease. Thus, for this purpose, the lessee must take into account ACRS deductions for the property and must disregard lease rentals and interests on lessee financing. In computing the imputed ACRS deductions for the property, the lessee must use the recovery period and method applicable to the lessor under the new safe-harbor rules.

For example, assume the lessee has $200 of foreign source income that is subject to a $92 foreign income tax, that the lessor's ACRS deductions for the property for the taxable year are $100 (computed by using the methods and recovery periods provided by the committee bill), and that the safe-harbor lease generates rental deductions of $75 and interest income of $25. Those are the only items of U.S. source income and deductions for the lessee. The lessee's U.S. tax computed with regard to the safe-harbor lease and before the foreign tax credit is $69 (($200 foreign source income + $25 interest income − $75 rental deductions) × 46 percent). Taking into account the safe-harbor lease, the foreign tax credit would be $69, which would eliminate all U.S. tax. However, the foreign tax credit must be computed by disregarding the safe-harbor interest and rentals and by taking into account $100 of ACRS deductions. In that case, the lessee would have $46 of U.S. tax (($200 foreign source income − $100 ACRS deductions) × 46 percent), which limits the foreign tax credit under the committee bill to $46. Thus, under the committee bill the lessee would pay $23 of U.S. tax ($69 of U.S. tax − $46 foreign tax credit).

Limitation on use by lessor

The bill provides a 50-percent limit on the amount by which a lessor can reduce its income tax liability (including any liability under the add-on minimum tax) through safe-harbor leasing in taxable years ending after July 1, 1982. That is, a lessor's tax liability is the greater of (1) 50 percent of the liability computed without regard to any rental income, interest deduction (if paid or incurred to the lessee), cost recovery deduction, and investment credit taken into account for the taxable year pursuant to a safe-harbor lease, or (2) the taxpayer's actual tax liability (computed with regard to those amounts).

When tax liability is determined by operation of the 50-percent limitation, deductions or credits from safe-harbor leases shall not be allowable in the current taxable year in the amount necessary to produce the proper amount of tax. Such deductions or credits may be carried forward. The Secretary shall prescribe regulations for determining the deductions or credits allowable in the current taxable year and the deductions or credits to be carried forward.

For example, assume that a lessor's tax would be $100 if rents, interest, depreciation, and investment credits from safe-harbor leases were excluded and $30 if they were included. The 50-percent limit would apply in this case and the lessor's tax liability would be $50 (50 percent of $100). In accordance with regulations which the Secretary shall prescribe, deductions or credits would not be allowable in the current taxable year sufficient to raise the lessor's tax from $30 to $50, and these deductions or credits would be carried forward.

No deferral of safe-harbor lease benefits will be required with respect to a safe-harbor lease that is not subject to the amendments made by the committee bill by virtue of the July 1, 1982, general effective date rule or the transition rules (as described below). However, these leases are taken into account first for taxable years ending after July 1, 1982, in determining whether there is a deferral of safe-harbor lease benefits for leases that are subject to the amendments made by the committee bill.

The committee bill also contains rules to prevent safe-harbor lessors from using tax benefits obtained through safe-harbor leasing to generate net operating loss or investment credit carrybacks to prior taxable years. Under these rules, a taxpayer's net operating loss carryback for any taxable year is reduced (and cannot be increased) by the portion of the carryback which is due to rental income, interest deduction (if paid or incurred to the lessee), depreciation deductions and investment credits relating to property with respect to which the taxpayer is the safe-harbor lessor. In determining the credit carryback, tax liability of the taxable year from which credits are to be carried is reduced first by credits not allocable to safe-harbor leases, and no credit allocable to a safe-harbor lease may be carried back.

Related person transactions

The bill also prevents the lessee from entering into a safe-harbor lease with a related person. For this purpose, persons are related if they are part of an affiliated group as defined in section 1504, even if the persons are not "includible corporations" (as defined in section 1504(b)) and even though the group does not file a consolidated return.

Effective Dates

Pre-ERTA lease rules

The provision of the committee bill affecting fixed price purchase options under pre-ERTA lease rules applies to leases entered into after December 31, 1984. The provision affecting terminal rental adjustment clauses applies on a retroactive basis to any open taxable year.

Safe-harbor lease rules

In general, the provisions affecting the safe-harbor lease rules apply to leases entered into or property placed in service after July 1, 1982. However, those provisions do not apply if (1) the property is placed in service before July 1, 1983, and (2) after June 25, 1981 (the date H.J. Res. 266, which contained the safe harbor leasing provisions, was ordered to be reported by the Senate Finance Committee) and before February 20, 1982, the lessee either (a) acquired the property or commenced construction of the property or (b) entered into a binding contract for the purchase of the property. For this purpose, a contract is not binding unless the lessee's failure to perform would subject him to liability for damages in an amount equal to or greater than 5 percent of the cost of the property.

The provisions affecting related party transactions and use of safe-harbor leasing to increase percentage depletion apply to leases entered into after February 19, 1982, without regard to binding contracts.

Special rule for mass commuting vehicles

The provisions of the committee bill modifying the safe-harbor rules generally do not apply to mass commuting vehicles (as described in sec. 168(f)(8)(D)(iv) as in effect before the amendments made by the committee bill) placed in service on or before December 31, 1987, pursuant to a contract or commitment that was awarded on the mass transit system on or before March 31, 1983. Change orders that do not affect the substance of the contract are permitted. A binding commitment for this purpose includes bids which have been accepted by the transit system but which may be subject to challenge by third parties. However, lessors of these assets will be subject to the 50-percent-of-tax-liability limitation on lessors provided by the committee bill. Thus, lessors must pay the greater of their tax liability or 50 percent of tax liability computed by disregarding any rental income, interest deductions, cost recovery deductions, and investment credit attributable to safe-harbor leases of mass commuting vehicles, as well as safe-harbor leasing of other property. Mass communting vehicles for which the March 31, 1983, contract date is not met will be subject to all provisions in the committee bill.

Sunset provision

The safe-harbor leasing provisions generally will be repealed for property placed in service after September 30, 1985. However, as noted above, a special rule applies for certain leases of mass commuting vehicles placed in service before January 1, 1988. For property placed in service before October 1, 1985, deductions or credits not allowed in a prior taxable year by virtue of the 50-percent limitation on reduction of lessors' tax liability will continue to be allowable for taxable years ending after September 30, 1985. For those years, taxable income and tax liability may be adjusted by virtue of the carryover items, subject to the 50-percent limitation.

Revenue Effect

The revenue gain is expected to be $1,145 million in fiscal year 1983, $2,876 million in 1984, $4,152 million in 1985, $5,729 million in 1986, and $7,192 million in 1987.

7. Foreign Tax Provisions

a. Limitation on credit for foreign income taxes imposed on foreign oil extraction income and current taxation of oil-related income (secs. 217 of the bill and secs. 907 and 954 of the Code)

Present Law

Foreign tax credit

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not be used to offset U.S. tax on domestic income.

The credit is available only with respect to foreign income, war profits, or excess profits taxes and certain "in lieu of" taxes (for ease of reference, referred to generally as foreign income taxes). Other taxes paid by the taxpayer are generally not creditable but are treated only as deductible expenses.[1]

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the computation of the foreign tax credit provides for a limitation to ensure that the credit offsets only the U.S. tax on the taxpayer's foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before foreign tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income divided by total worldwide taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

Present law also provides that a taxpayer is to compute the foreign tax credit limitation on a worldwide basis separately for his foreign oil-related income.[2] Thus, foreign taxes paid on the taxpayer's foreign oil-related income may not offset his U.S. tax on his other income and vice versa. A similar rule is applied with regard to certain interest income and DISC dividends. In general, the foreign tax credit limitation must be computed separately for passive interest income and for dividends from a DISC.

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[1] No inference should be drawn from this description of present law or from the actions taken in this bill that the committee agrees or disagrees that any current payments to foreign governments are properly treated as income taxes.

[2] The term "foreign oil-related income" includes the income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells, the processing of these minerals into their primary products, and the transportation, distribution, and sale of these minerals or primary products. The term also includes income from the sale or exchange of assets used in these activities. Finally, the term includes certain other income indirectly derived from these activities: in general, dividends (including deemed dividends under subpart F) and interest from foreign corporations in which the taxpayer has a 10-percent stock interest, foreign source dividends from a U.S. corporation, and the taxpayer's distributive share of the income of partnerships, to the extent the dividends, interest, or distributive share is attributable to foreign oil-related income of the intermediate corporation or partnership.

Under section 907, added to the Code in 1975 and later amended, an additional special limitation is placed on foreign income taxes on income from oil and gas extraction. Under the special limitation, amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed 46 percent (the highest U.S. corporate tax rate) of such extraction income.[3] Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible. However, a foreign tax credit carryover or carryback is allowed for excess extraction taxes paid to the extent of 2 percent of foreign oil extraction income.

The taxpayer's foreign extraction income is generally the sum total of the taxpayer's income and loss from worldwide foreign extraction operations. However, if the extraction activities and sales of the extraction assets in any single country result in a net loss for any year, the loss from that country is not taken into account in the computation of the foreign oil extraction income for the year. This special rule is referred to as the "per-country extraction loss rule" of sec. 907(c)(4). This rule has the effect of increasing a taxpayer's oil and gas extraction tax limitation by 46 percent of the nonincluded loss, which in turn generally increases the amount of oil and gas extraction taxes that the taxpayer can treat as creditable taxes. The per-country extraction loss is included, however, in computing the taxpayer's overall foreign tax credit limitation for foreign oil-related income for the year.

The effect of the per-country loss rule is to allow a company to use foreign oil extraction tax credits not only against foreign extraction income, but also against low-taxed non-extraction foreign trading, refining or shipping income. This occurs because foreign oil extraction income is not computed on a worldwide basis where there is a net loss in any country. To illustrate, if a company's extraction activities generated $300 income in country A on which it paid $138 of foreign income tax and a $100 loss in country B, it would have net income of $200 from those foreign extraction activities on which it would pay $92 of U.S. tax (at a 46-percent rate) before the foreign tax credit. However, because the $100 loss would not be taken into account in computing the 46-percent extraction limitation under present law, the company would be entitled to claim oil tax credits of $138 (46 percent of $300)—using $92 in credits against the U.S. tax on the net extraction income and the $46 excess credits against other oil-related income. The use of $46 of extraction tax credits to reduce U.S. tax on other income is generated only as a result of the per-country loss rule.

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[3] For purposes of this limitation, "foreign oil and gas extraction income" is the foreign source taxable income from extraction of minerals from oil and gas wells or from the sale of extraction assets. The term also includes certain other indirect income derived from these activities.

Subpart F income

Under present law, the United States subjects to tax the worldwide income of any corporation organized under the laws of the United States. However, foreign corporations (even those that are subsidiaries of U.S. companies) generally are taxed by the United States only to the extent they earn income from a business in the United States or derive investment income here. As a result, the United States usually does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. Instead, the foreign source earnings of a foreign corporation generally are subject to U.S. income taxes only when and if they are actually remitted to U.S. shareholders as dividends. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. U.S. tax on the dividend income may be offset by foreign tax credits.

An exception to the general rule is provided for certain "tax haven" base company type activities of controlled foreign corporations. These are foreign corporations more than 50 percent of the stock of which is owned by U.S. shareholders each of which owns at least 10 percent of the corporation's stock. The U.S. shareholders of these corporations are taxed under the subpart F provisions of the Code. Under these provisions, the earnings and profits of the controlled foreign corporation ("subpart F income") are deemed to be distributed to the U.S. shareholders, and are subject to taxation currently whether or not they actually receive the income in the form of a dividend.

There are five categories of subpart F income taxed currently to U.S. shareholders of controlled foreign corporations: (1) income from the insurance of U.S. risks; (2) passive investment income such as dividends, interest, royalties, and rents; (3) sales income earned by the foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated; (4) income from services performed for or on behalf of a related person by the foreign subsidiary outside of the country in which it is incorporated; and (5) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets.

Reasons for Change

Foreign tax credit

The Code has been amended in recent years to restrict further the foreign tax credit limitation in cases where the amount of foreign-source income could be manipulated for tax purposes and in cases where certain types of income often bear a rate of tax which is abnormally high or in excess of rates on other types of income.[4] These further limitations segregate different types of income, such as certain passive interest income or oil-related income, and attempt to permit only foreign taxes on the segregated type of income to be credited against U.S. tax on that type of income. Taxes on foreign oil and gas extraction income, under one of these rules, are generally intended to be creditable against U.S. tax on only foreign oil and gas extraction income, and not against U.S. tax on low-taxed, non-extraction trading, refining, shipping or non-oil-related income.

The committee has concluded that the special per country loss rule prevents the effective application of the special rule segregating oil and gas extraction income. By allowing extraction losses incurred in one country not to offset extraction income in another, creditable extraction taxes are overstated. This overstatement permits foreign taxes on extraction income to offset U.S. tax on foreign income from non-extraction sources, contrary to the general goal of segregating oil and gas extraction income and taxes.

Accordingly, the committee believes it is appropriate to repeal the special per country loss rule in order to limit the amount of creditable extraction taxes to no more than the taxpayer's U.S. tax on extraction income. In this manner the committee intends to assure that high rate foreign taxes on extraction income cannot be used to offset U.S. tax liability on other foreign-source income subject to a low rate of foreign tax.

The committee believes it appropriate to permit overall extraction losses in excess of overall extraction income to offset other income. However, the committee believes it appropriate to, in effect, recapture these losses to prevent timing differences from preventing effective application of the special extraction tax limitation.

Subpart F income

In addition to extraction income, multinational oil companies earn significant revenues from so-called downstream activities such as the transportation of petroleum, shipping, refining, trading and retail sales of the petroleum. Prior to 1975, the multinational oil companies had unfettered discretion to offset tax on their downstream income (often earned in low tax countries) with credits from high extraction taxes. In addition, they were able to use foreign losses to offset U.S. income.

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[4] When U.S. oil companies began operations in a number of major oil exporting countries, they only paid a royalty for the oil extracted since there was generally no applicable income tax in those countries. However, in part because of the benefit to the oil companies of imposing a foreign income tax, as opposed to a royalty, those countries have adopted taxes applicable to extraction income and have labeled them income taxes. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, many oil-producing nations in the post-World War II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies.

As the result of these increases in the effective tax rate, many oil-producing countries now impose taxes on oil income at effective rates as high as 80 percent or more, while the charges designated as royalties are imposed at relatively low rates (usually 20 percent or less) as compared to the taxes paid to those countries.

Even with the changes made in 1975 and succeeding years that limited the opportunity to use excess credits to shelter non-extraction income, multinational oil companies have paid relatively little U.S. tax on their foreign operations. In part, this is due to the special per country loss rule of section 907(c)(4) which provides that in computing the 46-percent limitation on extraction taxes, extraction losses are not taken into account if they arise in a country for which the taxpayer has a net extraction loss for the year and which the committee bill would repeal. When the downstream activities are conducted in a foreign subsidiary, however, U.S. tax generally can be avoided even if foreign income taxes are not sufficient to shelter all of the foreign income, since income of a U.S.-controlled foreign subsidiary is not subject to U.S. tax until that income is paid to its shareholders. Also, because of the fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.

The net result has been that the petroleum companies have paid little or no U.S. tax on their foreign subsidiaries' operations despite their extremely high revenue. The committee believes that all companies should pay U.S. tax on foreign oil related income earned in countries with taxes on that income below the U.S. rate. Accordingly, the committee bill applies the present law anti-tax haven provisions (subpart F) to tax currently certain low taxed foreign oil related income earned by foreign corporations controlled by U.S. persons. The committee recognizes that international shipping, because it is highly competitive and is generally not taxed by other countries, presents special problems. Accordingly, the tax treatment of that income should not be changed without further study.

Explanation of Provisions

Repeal of the per-country extraction loss rule

The bill repeals the special per-country extraction loss rule. Accordingly, when a taxpayer has a net extraction loss from a country for a year, the loss from that country will be taken into account in the computation of the foreign oil extraction income of the taxpayer for the year. For example, if a company's extraction activities generated $300 income in country A, on which it paid $138 of foreign income tax, and a $100 loss in country B, it will have net income of $200 from those foreign extraction activities on which it would pay $92 of U.S. tax (at a 46 percent rate) before the foreign tax credit. Because the $100 loss would be taken into account in computing the 46 percent extraction limitation, the company would be entitled to claim oil tax credits of up to only $92 (46 percent of $200). Therefore, the taxpayer would use $92 in credits against U.S. tax on net extraction income and could not use any excess extraction credits against other income.

The present law definition of the term "foreign oil and gas extraction income" for purposes of the special foreign tax credit limitation is retained.

The bill provides that in cases where a taxpayer has an overall foreign extraction loss in a year that reduces nonextraction income the loss is, in effect, to be recaptured in a subsequent year in which the taxpayer has overall foreign oil and gas extraction income. The recapture provision operates in substantially the same fashion as the overall foreign loss recapture provision in the Code (sec. 904(f)).

The loss recapture is accomplished by recharacterizing a portion of the foreign oil and gas extraction income earned in later years as foreign-source income that is not oil and gas extraction income. The amount of the foreign extraction income which is to be recharacterized as nonextraction income is equal to the amount of the extraction losses from prior years, but only to the extent that the losses have not been recharacterized in prior years. Recharacterization is to occur even though the taxpayer obtained no tax benefit from the loss.

For the purposes of this recapture provision, the term "overall foreign extraction loss" means the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to foreign oil and gas extraction income is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income (under sec. 862(b) or 863 of the Code). If no overall foreign extraction loss has been sustained in the case of an affiliated group of corporations filing a consolidated return, then no such loss is subject to recapture under this provision even if a member of the group had an extraction loss and the member is subsequently sold or otherwise leaves the group. In computing the amount of the foreign extraction loss, the net operating loss deduction (under sec. 172(a)) is not to be taken into account. In addition, foreign expropriation losses (as defined in sec. 172(h)(1) of the Code) or an extraction loss which arises from fire, storm, shipwreck, or other casualty, or from theft (unless the loss is compensated for by insurance or otherwise) are not subject to the recapture provision. A taxpayer is to be treated as sustaining a foreign extraction loss whether or not he claims a foreign tax credit for the year of the loss.

The bill repeals the limitation (to 2 percent of foreign extraction income) on carrybacks and carryovers of excess foreign oil and gas extraction taxes. The 2 percent limitation remains in effect, however, for carrybacks to taxable years beginning before January 1, 1983. Moreover, taxpayers may not carry forward to taxable years beginning on or after January 1, 1983, credits from taxable years beginning before that date in excess of the current 2 percent limitation. The taxpayer may not use any excess foreign oil and gas extraction taxes carried over from years beginning on or after January 1, 1983, to offset U.S. tax on any nonextraction income, but only to offset U.S. tax on foreign oil and gas extraction income. Thus, these taxes retain their character as extraction taxes in any year in which they are deemed paid (sec. 904(c)).

In cases where the taxpayer realizes an overall foreign loss, part or all of which is a foreign extraction loss, both the overall foreign loss recapture rule and the extraction loss recapture rule will apply. For example, if a company has an overall foreign extraction loss for a year of $100, $75 of other foreign income, and also $100 of U.S. income, the extraction loss first offsets the $75 of other foreign income and then offsets $25 of U.S. income. If in the subsequent year that company has $100 of foreign oil extraction income the prior year's overall foreign extraction loss would first recharacterize $25 of income as U.S. source income (sec. 904(f)) and would then recharacterize $75 of foreign oil extraction income as other foreign income. However, any foreign taxes imposed on the income that is recharacterized would not be recharacterized as anything other than extraction taxes; that is, extraction taxes always retain their character as extraction taxes.

The special foreign tax credit limitation for oil and gas income is repealed and the general foreign tax credit rules and the overall limitation of section 904 of the Code apply to oil and gas related income.

While the bill limits substantially the foreign tax credit for taxes paid to foreign countries with respect to foreign oil and gas extraction income, foreign tax credits are still permitted, subject to the general rules and the overall limitation of section 904, for taxes paid with respect to non-extraction oil-related income.

Under the bill, any foreign income taxes otherwise creditable under the Code which are paid or accrued to any foreign country with respect to foreign oil related income generally will be creditable against U.S. income taxes. Under a grant of regulatory authority, however, amounts are not creditable to the extent that the Secretary determines that the foreign law that imposes the tax is structured, or in fact operates, so that the amount imposed with respect to foreign oil nonextraction income will in most cases be materially greater than the amount generally imposed on income that is not oil-related income. The amount not treated as a tax under this provision will be treated as a deduction under the foreign law. Accordingly, the excess amount would be deductible for purposes of computing an appropriate level of foreign income tax and for U.S. tax purposes.

In determining the amount of taxes which are creditable, the Secretary would take into account the deemed foreign law deduction for amounts treated as excess payments under the provision when he recomputes the foreign tax paid. This is to assure that the rate of foreign tax on the oil profits after the deduction would not exceed the rate of tax generally imposed by the country on other income. This amount must be computed by the use of simultaneous equations.

For example, a foreign country has a generally applicable income tax of 40 percent but imposes an additional "tax" on oil-related income which results in a total of 55 percent. A company earning $100 of oil-related income on which it paid final oil "taxes" of $55 would, for purposes of computing the amount creditable as a foreign income tax, treat $25 of that payment as a deductible excess payment, leaving U.S. taxable income and foreign law taxable income for purposes of this computation of $75. The company would be entitled to treat the remaining $30 of the foreign tax as a credit against the $34.50 precredit U.S. tax on that $75 taxable income—leaving a net U.S. tax liability of $4.50. The amount of the foreign tax allowed as a credit

($30) would be 40 percent (the generally applicable tax rate of that country) of the $75 net taxable income from that country.

The present law definition of foreign oil related income generally is retained as the definition of foreign oil nonextraction income under the bill. However, foreign oil extraction income is excluded and related services income is included.

The provision contains special rules for the carryover of certain oil taxes. Under the carryover rules, foreign oil-related taxes paid in taxable years beginning before January 1, 1983, can be carried back two years and carried forward five years under the regular foreign tax credit rules. However, the amount of oil-related taxes carried to a taxable year beginning on or after January 1, 1983, cannot exceed the amount that would have been creditable if the provisions of this Act had been in effect in the year in which the foreign taxes were paid. A further limitation is provided under which the old foreign tax credit rules relating to foreign oil-related income will be deemed to be in effect for the excess credit year (the year in which the taxes were paid), and for all taxable years thereafter. A similar rule is provided to limit carrybacks of taxes paid after 1982 to pre-enactment years.

Current taxation of foreign oil and gas nonextraction income of foreign subsidiaries

The bill would impose current U.S. tax on foreign oil and gas nonextraction income earned by a controlled foreign corporation. This would be accomplished by treating foreign oil nonextraction income as an additional category of foreign base company income currently included in the U.S. shareholder's income under subpart F. This additional category of income is called foreign base company oil and gas nonextraction income.

Foreign base company oil nonextraction income is income derived from sources outside the United States from the processing of minerals extracted (by the taxpayer or any other person) from oil or gas wells into their primary products and the distribution of oil or gas minerals or primary products.[5] Income from the performance of services related to oil and gas extraction or nonextraction activities is oil and gas nonextraction income if the person performing the services or a related person is engaged in oil and gas extraction activities. Thus, for example, income of a contract driller would not be foreign oil or nonextraction income (or extraction income). Services include, for example, transportation of oil (other than foreign base company shipping income), accounting or managerial services, or insuring oil extraction or nonextraction assets. Foreign base company oil nonextraction income also includes the sale or exchange of an asset used by the taxpayer in a trade or business encompassing one of these activities, but only if 50 percent or more of the income attributable to the asset for the three taxable years of the selling corporation immediately preceding the year of sale was foreign base company oil nonextraction income.

Foreign base company oil nonextraction income also includes dividends and interest from a foreign corporation with respect to which taxes are deemed paid by the taxpayer, dividends from a domestic corporation which are treated as income from sources without the

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[5] For example, foreign base company oil or gas related income includes income of a foreign subsidiary located in country A that purchases oil from foreign government B and sells the oil to an unrelated person in country C.

United States under the Internal Revenue Code, amounts with respect to which taxes are deemed paid under the present subpart F provisions of the Code, and the taxpayer's distributive share of the income of partnerships. These amounts are treated as foreign oil nonextraction income, however, only to the extent they are attributable to foreign oil nonextraction income. In addition, interest from a foreign corporation and dividends from a domestic corporation which are treated as foreign source are foreign base company oil and gas nonextraction income to the extent attributable to foreign oil and gas extraction income. Thus, such interest and dividends are oil nonextraction income even though foreign oil and gas extraction income is not foreign base company oil and gas nonextraction income.

Consistent with the base company concept, two exceptions to current taxation are provided. First, foreign oil nonextraction income derived from sources within a foreign country in connection with oil or gas which was extracted by anyone from an oil or gas well in that foreign country would not be subject to the current taxation rules. For example, income derived in a foreign country by a subsidiary from the purchase and sale of oil extracted in that country would not be treated as subpart F income, but income the subsidiary derives from the purchase and sale of oil extracted in a second country would be subpart F income. Second, foreign oil nonextraction income derived from sources within a foreign country in connection with oil, or gas, or a primary product of oil or gas which is sold by that foreign corporation or by a related person for use or consumption in that country would not be subject to current taxation rules.

For example, if a controlled foreign corporation had income from refining in country A, and half of the income of the corporation was from refining oil extracted by the corporation in country A and half elsewhere, only half of its income would be base company income.

Shipping income which is foreign based company shipping income would not be subject to current tax in the hands of U.S. shareholders as foreign base company oil nonextraction income. It would, however, continue to be subject to the provisions of subpart F relating to foreign base company shipping income.

The exception from foreign base company income in subpart F for foreign corporations not availed of to reduce taxes does not apply to foreign base company oil and gas nonextraction income.

Effective Dates

The provision generally applies to taxable years beginning on or after January 1, 1983, and to losses realized after that date. The provision relating to excess payments of foreign oil related taxes applies to payments made on or after January 1, 1983. The provision relating to current taxation of certain oil-related income of foreign subsidiaries of U.S. oil companies applies to taxable years of foreign corporations beginning on or after January 1, 1983, and to taxable years of United States shareholders within which or with which such taxable years of foreign corporations end.

Revenue Effect

It is estimated that this provision will increase budget receipts by $233 million in fiscal year 1983, $504 million in 1984, $581 million in 1985, $649 million in 1986, and $708 million in 1987.

b. Allocation of possessions corporation intangibles income to U.S. shareholders; increase in active income test for qualification as possessions corporation; related Virgin Islands provisions (sec. 218 of the bill and secs. 246, 934 and 936 of the Code)

Present Law

In general

The possessions of the United States, including Puerto Rico, the U.S. Virgin Islands, Guam, and American Samoa, are subject to tax rules sometimes different from those generally in effect in the 50 States and the District of Columbia. Through some of these special rules, Congress has sought to encourage U.S. corporate investment in the possessions. Certain investment incentive programs established by the possessions have complemented the special Federal tax rules in inducing U.S. corporate investment.

Puerto Rico and the other possessions (except the Virgin Islands)

Section 936 of the Internal Revenue Code provides a special tax credit for certain income of certain U.S. corporations operating in Puerto Rico and possessions of the United States, other than the Virgin Islands. This tax credit (called the section 936 credit) is given in lieu of the ordinary foreign tax credit provided in sec. 901 of the Code.

Any domestic corporation which elects to be a section 936 corporation can receive the section 936 tax credit if it satisfies two conditions. First, 80 percent or more of its gross income for the 3-year period or applicable part thereof immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, 50 percent or more of its gross income for that period must be derived from the active conduct of a trade or business within a possession (or possessions).

A section 936 corporation is generally subject to tax on worldwide income in a manner similar to that applicable to any other U.S. corporation, but a full credit is given for the U.S. tax on the business and qualified investment income from possessions regardless of whether any tax is paid to the government of the possessions. The effect of this treatment is to exempt from tax the income from business activities and qualified investments in the possessions and the income from disposition of a possession business. All other income of section 936 corporations (with allowance for the usual foreign tax credit for foreign taxes paid with respect to foreign source income) is taxed currently.

Qualified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income that taxable year). The taxpayer must establish to the satisfaction of the Secretary that the funds invested were derived from the active conduct of a trade or business within that same possession and were actually invested in assets in that possession. Income from sources within the possession attributable to reinvestments of qualified possession source investment income is also treated as qualified possession source investment income. Funds placed with an intermediary (such as a bank located in the possession) are treated as invested in that possession only if it can be shown that the intermediary did not reinvest the funds outside the possession.

To avoid a double credit against U.S. taxes if a corporation is eligible for the section 936 credit, any actual taxes paid to a foreign country or a possession with respect to the gross income taken into account for the credit are not treated as a creditable tax under sec. 901 of the Code, and no deduction is allowed with respect to that tax. Thus, the section 936 credit replaces entirely any regular foreign tax credit and any deduction for foreign income taxes paid which otherwise would be allowed with respect to the income taken into account.

Since the section 936 tax credit is separate from the tax credit permitted under section 901, and since most of a possessions corporation's income must be foreign source, the limitation under section 904 of the Code does not apply to income subject to a section 936 credit, and such income is not taken into account in computing the limitation on the amount of allowable tax credits (under sec. 904 of the Code).

The section 936 credit generally is allowed against taxes imposed by chapter 1 of the Internal Revenue Code. However, the credit is not available against any minimum tax for tax preferences (sec. 56 of the Code), any tax on accumulated earnings (sec. 531 of the Code), taxes relating to recoveries of foreign expropriation losses (sec. 1351 of the Code), or the personal holding company tax (sec. 541 of the Code). In computing the amount of U.S. tax paid by the corporation which is attributable to active trade or business in a possession and qualified investment income, taxes paid relating to the items described above are not taken into account.

An electing section 936 corporation cannot join in a consolidated U.S. tax return with related taxpayers. The election must remain in effect for 10 taxable years (so long as the corporation meets the income qualifications) unless the Secretary consents to revocation.

Dividends received from a section 936 corporation are eligible for the 100-percent dividends-received deduction or the 85-percent dividends-received deduction under section 243. No credit or deduction is allowed for income taxes paid to a possession or foreign country with respect to repatriation of the earnings of a section 936 corporation, however.

Puerto Rico generally has matched the United States' tax incentives with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from income taxation certain passive income, such as interest on fixed-term deposits in qualifying banks, in the hands of certain companies to which it has granted investment incentives.

The U.S. Virgin Islands

Although the section 936 possession corporation rules do not apply in the Virgin Islands, a different set of rules provides similar tax incentives for U.S. investment there.

In the Virgin Islands, the U.S. Internal Revenue Code is generally applied as a local territorial tax code, except that tax proceeds are paid into the treasury of the Virgin Islands. In applying the Internal Revenue Code in the Virgin Islands, the name "Virgin Islands" is generally substituted for the name "United States" wherever it appears in the U.S. Code.

Corporate and individual "inhabitants" of the Virgin Islands satisfy their U.S. income tax obligations by paying tax to the Virgin Islands on their worldwide income, including U.S. source income. All corporations chartered in the Virgin Islands are considered to be "inhabitants" of the Virgin Islands. In certain circumstances a United States corporation may also qualify as an "inhabitant" of the Virgin Islands.

The United States subjects to tax dividends paid by a Virgin Islands ("V.I.) subsidiary to a U.S. parent. Dividends paid by a U.S. subsidiary that is a V.I. inhabitant to its U.S. parent qualify for an 85-percent dividends received deduction.

The Internal Revenue Code limits the power of the Virgin Islands government to grant relief from its income tax (sec. 934). The Virgin Islands is prohibited from granting rebates for taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, the Virgin Islands is precluded from granting corporate tax rebates except to U.S. and V.I. corporations that have derived for the past 3 taxable years (or applicable part thereof) at least 80 percent of their gross income from V.I. sources and at least 50 percent of their gross income from the active conduct of a trade or business within the Virgin Islands (sec. 934). Acting within the constraint of this test, the Government of the Virgin Islands has established further criteria for rebates of tax on V.I. source business income, such as a $50,000 minimum investment and certain employment criteria.

In effect, U.S. corporate inhabitants of the Virgin Islands may obtain tax benefits substantially similar to those available under section 936 for possessions corporations. To date, however, unlike Puerto Rico, the Virginia Islands has not provided tax relief for interest income.

Reasons for Change

In general

In connection with the Tax Reform Act of 1976, the Congress directed the Department of the Treasury to report annually on the possessions corporation system of taxation. Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of excessive possession source investment income.

Qualified possession source investment income

Treasury's third annual report, the latest issued to date, indicates that by the end of 1979, financial (as opposed to physical) investment of section 936 corporations in Puerto Rico amounted to some $4.6 billion, of which some $2.9 billion was in certificates of deposits in

Puerto Rican banks.[3] These financial investments were generally subject to no U.S. or Puerto Rican tax. According to the third Treasury report, this benefit apparently did not greatly increase net capital flows into Puerto Rico over what they otherwise would have been. Funds which flowed into Puperto Rico through financial investments by section 936 corporations tended to flow out again through the banking system. Therefore, the exemption of qualified possession source investment income from U.S. tax apparently provided little net new capital to allow investors to acquire new plant and equipment. In fact, the exemption appeared to be permitting taxpayers to shelter significant amounts of passive income. Therefore, the Committee believes that some limitation of the effective exemption of investment income is necessary.

Allocation of intangibles income

Under present law, some taxpayers have taken the position that they may make tax-free transfers of intangible assets created or acquired in the United States (such as patents, secret processes, and trademarks) to an electing section 936 corporation, and that no allocation of income generated by those intangibles to the U.S. parent is required. The view of the Internal Revenue Service is that the Service must make an allocation to the U.S. parent of all or a portion of the income attributable to the intangibles. This issue is now before the U.S. Tax Court, and has created widespread uncertainty among taxpayers. It could take many more years before this issue is ultimately resolved by the judicial process.[4] Because a section 936 corporation is a domestic corporation, a ruling is not required to obtain tax-free treatment on the transfer.

For instance, a U.S. pharmaceutical company may spend (and deduct or amortize and take a research and development tax credit for) large sums on research and development of new drugs. When it develops an effective drug, it may transfer the patent on the drug and the know-how to manufacture the drug to a section 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936 company might manufacture the drug and claim the extremely high profits which typically result from the sale of pharmaceutical products. It is the committee's understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all the unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g., patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to their developer (the U.S. parent), a distortion of income results, with the parent obtaining deductions for its efforts while the 936 company realizes tax-free income.

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[3] The Treasury report indicates that this accumulation of financial assets distorted the balance sheets of both banks and investing section 936 corporations. The $2.9 billion of bank deposits by possessions corporations at the end of 1979 constituted some 34 percent of all deposits in Puerto Rican banks. At the end of 1978, retained earnings represented 77 percent of total liabilities and shareholders' equity of all manufacturing possessions corporations. The comparable figure for all U.S. manufacturing corporations was between 39 and 41 percent.

[4] No inference should be drawn from this report or from the actions taken in this bill that the committee agrees or disagrees with either the taxpayers involved or the Internal Revenue Service about this issue.

The Treasury Department's annual reports have documented the cost of increased Puerto Rican employment in terms of U.S. revenue loss from section 936. While the possession credit has attracted Puerto Rican investment that has increased employment, the revenue cost per affected employee is greater than average wages paid, particularly in intangible intensive industries. For example, in 1978, the Federal tax expenditure per Puerto Rican employee averaged $12,667 in all manufacturing industries as compared with an average compensation of possessions corporation employees of $10,667. In intangible intensive industries, such as pharmaceuticals, the tax expenditure in 1978 averaged $43,261 as compared to an average employee compensation of $13,618. For nine particular Puerto Rican possession corporations, the tax expenditure per employee exceeded $100,000 in 1978. In 1978, 50 percent of the total tax expenditure was attributable to the pharmaceutical industry which accounted for only 15 percent of all Puerto Rican manufacturing jobs or approximately 3 percent of total Puerto Rican employment. Moreover, according to Treasury's third report, intangible intensive industries generally do relatively little to encourage the development of related industries in the possession, because their customers and suppliers are generally not in the possession.

The committee believes that no legitimate policy is served by permitting tax-free generation of income related to intangibles created, developed or acquired in the United States or elsewhere outside of the possession since that income is not derived from increased Puerto Rican employment or economic activity. Therefore, the committee believes that ending the availability of the possession credit for income from such intangibles is justified.

Virgin Islands provisions

The Committee has not concluded that U.S. taxpayers are abusing the Virgin Islands tax system. Nonetheless, the Committee believes that the current V.I. system is susceptible of abuse. Moreover, the Committee believes that the reform of the possessions corporation system could induce some taxpayers to attempt to abuse the V.I. system. Therefore, the Committee has drafted revisions of the V.I. system that parallel the revision of the possessions corporation system.

Explanation of Provisions

Qualified possession source investment income

The committee bill changes the active trade or business test that a U.S. corporation must meet to qualify for the possession tax credit.

It replaces the current requirement (that 50 percent or more of the corporation's gross income for the three-year period immediately preceding the close of the taxable year be derived from the active conduct of a trade or business in a possession) with a new requirement: that, for taxable years beginning in 1985, 90 percent of the corporation's gross income for the three-year period immediately preceding the close of the taxable year come from the active conduct of a trade or business in a possession. The provision is phased in so that the required percentage rises to 65 percent for taxable years beginning in 1983 and to 80 percent for taxable years beginning in 1984.

The bill does not alter the current definition of qualified possession source investment income. The bill also does not alter the current requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. A corporation must meet both the 80-percent possession source income test and the 90-percent active trade or business test. Meeting the 90-percent trade or business test does not guarantee satisfaction of the 80-percent possession source income test, because a company might derive all its income from a possession business while deriving more than 20 percent of that income from sources outside the possession.

The committee recognizes that under the other major modification of section 936 contained in this bill and described below, the Internal Revenue Service or the courts may in later years treat certain active income as income of a taxpayer other than the section 936 corporation. Such treatment could, absent relief, cause retroactive disqualification under section 936, and a resulting loss of the section 936 credit. To provide a remedy, the bill allows section 936 corporations to make "distributions to meet qualification requirements" to their shareholders in later years. The bill allows section 936 corporations to treat these distributions as consisting wholly of disqualifying income. The U.S. recipients of such distributions must include them in income in the year received, without the dividends received deduction. Recipients of such distributions who are nonresident aliens or foreign corporations, estates or trusts are to be taxed in the same manner as if the recipient were a U.S. person. This is accomplished by designating this income as "effectively connected" with the conduct of a trade or business through a permanent establishment of such person within the United States. In this way a section 936 corporation may avoid retroactive disqualification.

However, a distribution to meet qualification requirements is not available when the failure to meet the test was due to fraud or wilful neglect.

Allocation of income attributable to intangibles

The bill provides that income attributable to intangible assets owned or leased by a section 936 corporation generally is not income of the section 936 corporation but is instead the income of the corporation's U.S. shareholders, with proration of income on the basis of shareholdings. The purpose of this provision is to subject to U.S. tax income attributable to intangibles that add value to the products produced by a section 936 corporation but that are not solely developed by the section 936 corporation within a possession or purchased from an unrelated person.

A different rule applies to the extent that shareholders of the section 936 corporation are foreign persons or are not subject to tax on such income. In such a case, the pro rata portion of the intangible property income that would have been allocated to such persons (if they had been U.S. persons subject to tax on such income) is instead treated (for the purpose of determining the tax liability of the section

936 corporation) as U.S. source income of the section 936 corporation. The section 936 possessions credit cannot offset this intangible property income. However, such intangible property income of the section 936 corporation does not enter into the calculation of the 80-percent possession source test or the 90-percent active trade or business test. In summary, the 936 corporation will be subject to U.S. income tax on intangible property income that is not allocated to shareholders (because they are foreign or tax-exempt), but such income will not operate to disqualify the corporation as a section 936 corporation.

For example, if a section 936 corporation has only $1,000 of gross income from an active business in Puerto Rico and from Puerto Rican sources, and $600 of that gross income is intangible property income, U.S. taxpayers will be subject to tax on the $600 intangible property income. If, in the same example, 80 percent of the shares of the 936 company are held by a U.S. corporation (which is not a 936 company), 10 percent by a foreign corporation, and 10 percent by a U.S. pension plan, the U.S. corporation is taxable on $480, while the section 936 company is taxable on $120. The U.S. shareholder is not entitled to a dividends received deduction for the $480, because this amount is not a dividend, but is rather intangible property income. The section 936 credit is not available to offset the tax on the $120 of intangible property income earned by the section 936 corporation. The $120 is also U.S. source income for purposes of the 936 company's foreign tax credit limitation. Because, for purposes of the 80 percent possession source test and the 90 percent active business test (taking into account only the year described), the 936 company's gross income for the year described does not include any intangible property income, in the example above the 936 company's gross income for these purposes is $400 and both tests are met. In this example, all $400 is both from an active Puerto Rican business and from Puerto Rican sources; therefore, the section 936 corporation has 100 percent possession source income and 100 percent active possession business income.

The bill defines intangible assets broadly to include patents, inventions, formulas, processes, know-how, designs, patterns, copyrights, literary, musical, or artistic compositions, company names trademarks, trade names, brand names, franchises, licenses, contracts, methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other items similar to any of those listed, so long as the item has substantial value independent of the services of individual persons.

Intangibles the income from which is allocated to U.S. persons generally include those intangibles whose value is reflected in the price received by the section 936 corporation on any disposition of property. However, there is no allocation of income to U.S. persons in the case of income from intangibles developed solely by the section 936 corporation in the possession and income from intangibles acquired from an unrelated party. An intangible developed under a cost-sharing arrangement does not qualify as developed solely by the section 936 corporation.

Income attributable to intangibles includes the amount received in excess of a reasonable return on any sale the price of which reflects the value of intangible assets. A reasonable return for a section 936 corporation consists of the reasonable direct and indirect costs it incurs in manufacturing the product (other than costs incurred in connection with intangibles) plus a reasonable profit margin. Costs do not include the cost of materials which are subject to processing or which are components in a product manufactured by the section 936 corporation. Also, costs do not include interest expense.

The bill generally treats a section 936 corporation as related to another person if such persons are related parties for purposes of sections 267(b) or 707(b)(1) or members of the same controlled group of corporations (as defined in section 1563(a)), except that the bill substitutes a greater than 10 percent test for the 50 percent or 80 percent tests of these sections and includes otherwise excluded foreign affiliates.

In the hands of a U.S. shareholder, income attributable to intangibles will be U.S. source income. As a practical matter, creditability of any income tax imposed by a possession on such U.S. source income will depend on the U.S. shareholder's overall foreign tax credit limitation, which limits the credit to the taxpayer's U.S. tax liability on foreign source income.

The bill's allocation to U.S. shareholders of intangible property income is effective even though such shareholders may not actually have received those amounts. Ordinarily, the actual receipt of such amounts, already included in income, will not trigger additional tax liability in later years. The committee anticipates that the Internal Revenue Service will establish correlative and similar adjustments (such as those provided in Revenue Procedure 65–17, as amplified and amended) to provide for the exclusion, when appropriate, of previously taxed amounts. However, if the Internal Revenue Service later increases the U.S. shareholder's income for the year in which the intangible property income was earned because the U.S. shareholder, due to fraud or with a principal purpose of avoiding tax, did not include his allocable share of intangible property income in his return for that year, the U.S. shareholder will not be able to exclude such amounts on receipt.

Virgin Islands provisions

The bill creates rules for the Virgin Islands similar to those for the other possessions. The bill would prevent U.S. companies that are "inhabitants" of the Virgin Islands from earning passive investment income free of U.S. and V.I. taxes by providing that the Virgin Islands may not grant tax rebates to any U.S. corporation unless that corporation meets a 90 percent active trade or business test identical to that provided for section 936 corporations. As is the case with section 936 corporations, the bill provides a phase-in of the 90 percent test and a method to qualify under this test retroactively if allocation of income from intangibles to related U.S. parties was inadequate.

The bill would prevent U.S. corporations that are inhabitants of the Virgin Islands from earning virtually tax-free income attributable to certain intangibles by requiring allocation of such income to U.S. shareholders of the V.I. inhabitant. The rules for such allocation are the same as the rules described above for section 936 corporations. To the extent that the shareholders of the V.I. inhabitant are foreign persons, V.I. inhabitants or other persons not subject to U.S. taxation, the bill prevents the Virgin Islands from exempting the V.I. inhabitant from tax on intangible property income.

Effective Date

These provisions are effective for taxable years beginning on or after January 1, 1983.

Revenue Effect

It is estimated that these provisions will increase fiscal year budget receipts by $412 million in 1983, $1,027 million in 1984, $1,251 million in 1985, $1,356 million in 1986, and $1,470 million in 1987.

c. Deductibility of payments under the Foreign Corrupt Practices Act (sec. 294 of the bill and sec. 162 of the Code)

Present Law

No deduction is allowed for payments to foreign government employees or officials if such payments would be illegal under any of the Federal laws of the United States, if the laws of the United States were applicable to the transaction (sec. 162(c)(1)). Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covers most conceivable situations where foreign bribes, kickbacks or similar payments are made.

Payments by a foreign corporation controlled by U.S. shareholders that are not deductible under the illegality test of section 162(c) also constitute income to the U.S. shareholders under the subpart F provisions of the Code. Such payments do not reduce the controlled corporation's earnings and profits. In addition, payments non-deductible under this illegality test constitute a deemed distribution to shareholders of a Domestic International Sales Corporation ("DISC"), and thus reduce the tax deferral benefits of a DISC. Present law thus attempts to prevent any reduction in tax arising from the payment of foreign bribes.

In a further attempt to curtail foreign bribes by U.S. businessmen Congress enacted the Foreign Corrupt Practices Act of 1977 ("FCPA"). In general, this Act makes it illegal for U.S. persons or their agents to make, offer, or authorize, either directly or indirectly, payments to foreign government officials, foreign political parties, or foreign political candidates with the intent of influencing official action in order to obtain business. Violations of FCPA can result in fines of up to $1 million for corporations and $10,000 for individuals, and imprisonment for up to five years.

Reasons for Change

The committee believes that a single standard of legality for payments to foreign government personnel is appropriate for both the Foreign Corrupt Practices Act and the Internal Revenue Code. In some cases, the current tax law test may be overly harsh. Moreover, the current tax law test, which requires a hypothetical determination of U.S. law, may need clarification.

Explanation of Provision

The bill amends the provision disallowing a deduction for payments to foreign officials that would be illegal under Federal law if Federal law applied to the transaction to disallow a deduction only where the payment was in violation of the Foreign Corrupt Practices Act. This change limits the applicability of Code section 162(c)(1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act. Because nondeductibility of a payment depends upon the definition of an illegal payment under the FCPA, the disallowance standard will change with any future amendments of the FCPA.

There are two principal types of payments that are allowed as a deduction under the bill that are not deductible under present law. The first are facilitating or "grease" payments. These are payments made to government officials to facilitate routine administrative actions that are nondiscretionary on their part. Thus, payments to a customs official to expedite goods through customs are allowed as a deductible payment under the bill.

The second type of payment that is deductible under the bill is one that is a legal payment under the local law of the foreign jurisdiction but which would violate a Federal law other than the Foreign Corrupt Practices Act.

The amendment to the deductibility rule of section 162(c) will similarly change the tests for inclusion as subpart F income, denial of reductions in earnings and profits, and denial of DISC deferral.

Effective Date

This provision will be effective for payments made after the date of enactment.

Revenue Effect

It is estimated that this provision will decrease fiscal year budget receipts by $30 million in 1983 and each year thereafter.

8. Tax-Exempt Obligations

a. Restrictions on tax-exempt bonds for private activities (secs. 221, 222, and 223 of the bill and secs. 103 and 168 of the Code)

Present Law

General rule

Interest on obligations issued by or on behalf of State and local governments generally is exempt from Federal income tax. However, subject to certain exceptions, interest on State and local issues of industrial development bonds (IDBs) is taxable. An obligation is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization (described in sec. 501(c)(3)), and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Exceptions for certain financings

Present law provides an exception which exempts from tax interest on IDBs that are issued to finance the following types of exempt activities: (1) projects for low-income residential rental property, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass commuting facilities, and parking facilities, (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electricity or gas, (6) air or water pollution control facilities, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, and (9) qualified mass commuting vehicles. In addition, the interest on certain IDBs issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Present law also allows tax-exempt financing for student loans and organizations that qualify for tax exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions.

"Small issue" exception

Present law also provides an exception to the general rule of taxability for interest paid on IDBs for certain "small issues." The interest on small issue IDBs is exempt if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. This exception applies to issues of $1 million or less without regard to the total capital expenditures for the facility (the $1 million "clean limit" exception). At the election of the issuer, the limitation may be increased to $10 million, subject to certain restrictions. In the case of facilities with respect to which an urban development action grant ("UDAG grant") under the Housing and Community Development Act of 1974 has been made, capital expenditures of up to $20 million are allowed.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding small issues for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. In addition, the $10 million limitation is reduced to the extent that principal users of the facilities incur certain capital expenditures in the same county or same incorporated municipality.

Other rules

Under present law, facilities financed with tax-exempt IDBs may be depreciated under the Accelerated Cost Recovery System (ACRS) and may qualify for the investment credit.

Present law imposes no reporting requirement on issuers of tax-exempt bonds for private activities. Additionally, there are no Federal procedural requirements governing the manner in which such bonds are issued.

Reasons for Change

In general

The committee is concerned with the use of tax-exempt bonds used for private activities. There has been a tremendous increase in recent years in the volume of such bonds. In 1976 the volume of private activity bonds was about $8.5 billion, or about 25 percent of the long-term tax-exempt bond market. The volume of private activity bonds rose to more than $25 billion in 1981, representing 48 percent of the tax-exempt bond market. The Treasury Department estimates that over $35 billion of private activity bonds will be issued in 1982, consuming over 55 percent of the entire long-term tax-exempt bond market.

The proliferation of private activity bonds has contributed to a significant narrowing of the difference in interest rates between tax-exempt and taxable bonds. While the tax-exempt rate historically has been about 65 to 75 percent of the taxable rate, tax-exempt bonds are now generally yielding about 80 to 85 percent of the taxable rate. This erosion of the relative advantage of tax-exempt financing has made it more costly for state and local governments to finance essential public projects such as schools, roads and prisons. It also has made tax-exempt financing even less cost effective as a subsidy for private activities, since more of the benefit is siphoned off for bond investors as tax-exempt rates grow closer to taxable rates. The increasing volume of private activity bonds has also caused mounting Federal revenue losses. The Treasury Department estimates that the total Federal revenue loss from private activity tax-exempt bonds outstanding in fiscal year 1981 was $3.2 billion and will be $4.2 billion for private purpose obligations outstanding in fiscal year 1982.

While the growth of private activity bonds in recent years has been large, information concerning the specific uses is incomplete. Accordingly, in order to enable the Congress and others to monitor the use of tax-exempt bonds for private activities and to help in enforcing other restrictions on industrial development bonds [IDB's], the committee bill requires issuers to make quarterly reports to the Internal Revenue Service on private activity tax-exempt obligations issued by them.

The availability of tax-exempt financing for exempt activities and other private activities causes distortions in the allocation of scarce capital resources. The ability to obtain a lower cost of borrowing for certain activities (for example, businesses requiring pollution control facilities) through the use of tax-exempt financing creates a bias in favor of investment in those activities. In effect, those favored activities (for example, businesses that create pollution) are subsidized at the expense of other activities. Thus, the allocation of capital investments is based upon government decisions rather than their relative economic productivity.

Industrial development bonds

The committee believes that new restrictions are needed on IDBs to help eliminate inappropriate uses and to help restore the benefit of tax-exempt financing for traditional governmental purposes. However, the committee believes that, in general, State and local governments are best suited to determine the appropriate uses of IDBs. The committee believes that providing tax exemption for the interest on certain IDBs may serve legitimate purposes in some instances provided that the elected representatives of the State or local governmental unit determine after public input that there will be substantial public benefit from issuance of the obligations and provided that the affected public has had an apportunity to comment on the use of tax-exempt financing for particular facilities. In order to achieve this goal, the committee bill requires notice and a public hearing and approval by an elected representative of the issuer before issuance of any IDBs.

The committee is also concerned with the combined subsidies provided for investment from the tax rules for cost recovery, investment tax credit and tax-exempt financing. In most cases, the committee believes that the combined subsidies are too generous. Consequently, the committee believes that new restrictions in cost recovery deductions taken by private taxpayers for property financed by IDBs are necessary. Therefore, the committee bill requires taxpayers to choose between (1) ACRS and conventional financing and (2) tax-exempt financing and a slower rate of cost recovery than that provided by ACRS. The committee does not believe such a requirement will reduce the use of IDBs in appropriate circumstances, but will simply eliminate an unnecessary portion of the total subsidy available to the user of the bond proceeds.

The committee believes that extraordinary levels of subsidy are necessary in the case of certain types of property. In those cases, both tax-exempt financing and the full ACRS deductions should be available. The committee believes that additional levels of subsidy are appropriate for low income rental housing, municipal solid waste disposal facilities, air and water pollution control facilities installed in existing plants, and projects financed in part with a UDAG grant.

Small issue industrial development bonds

The committee is also particularly concerned with the extraordinarily rapid growth in the volume of small issue IDBs. In 1976, according to the Treasury Department, the volume of new, small issue IDBs was $1.4 billion. In 1981, that volume had grown to $10.5 billion, an annual rate of growth of 50 percent. By contrast, public activity bonds grew at an annual rate of approximately 1 percent during the same period. Continued growth in the use of small-issue tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. Under present law, for instance, the annual volume of new small issues by 1987 is estimated to be $31.3 billion.

In addition to its concern with the increasing volume of small issue bonds, and the impact of that volume on the market for public purpose tax-exempt securities, the committee is concerned with (1) the use of small issue IDBs by large companies that are able to raise funds readily in capital markets without a federal subsidy, (2) the use of small issue IDBs to finance a variety of types of facilities, from private recreational facilities to fast food restaurants, that generally may be less deserving of a Federal credit subsidy than other types of facilities, and (3) the lack of any substantial targeting of the use of small issue IDBs to economically distressed or otherwise needy areas.

While the committee considered several alternatives to limit the volume and reform the use of small issue IDBs, the absence of comprehensive and reliable information regarding the uses of small issue IDBs hampered the committee's capacity to determine the appropriate role, if any, to be played by small issue IDBs for the future. Instead, the committee determined that the use of small issue IDBs should be terminated after 1985. The committee does not intend by the bill to preclude further consideration by Congress of the appropriate use of small issue IDBs. Indeed, the committee anticipates that Congress will undertake, in a timely manner and with substantially more information than is presently available, a comprehensive review as to whether the continued use of small issue IDBs is economically warranted, and, if so, how that use should be further restricted.

Explanation of Provisions

Overview

The bill requires issuers of private activity bonds to make quarterly information reports to the Internal Revenue Service with respect to each issue; requires approval of IDB issues by an elected official or legislative body following a public hearing before issuance (or, in lieu of such approval and hearing, a voter referendum conducted); reduces, with certain exceptions, cost recovery deductions for IDB-financed property; eliminates use of the small issue exception for IBDs issued as part of a single issue with bonds exempt under any other provision; and repeals the small issue exception for obligations issued after 1985.

Information reporting requirements

Under the committee bill, issuers of all bonds used to finance private activities are required to report certain information to the IRS on such bonds issued by them during the preceding calendar quarter. This report must be made no later than the 15th day of the second month after the close of the calendar quarter in which the bonds are issued. The reporting requirement applies to all IDBs, student loan bonds,[1] and tax-exempt bonds a major portion of the proceeds of which are used by charitable, etc., organizations (described in sec. 501 (c)(3)). The required reporting also applies to refunding issues even if the original bonds were issued before 1983, if the refunding occurs after 1982.

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[1] Student loan bonds include State and local government bonds used to finance, directly or indirectly, any educational or related expenses regardless of whether the bonds are guaranteed by the Federal or State governments.

The quarterly report must contain substantially all of the following information with respect to each issue:

(1) the date of the issue, the stated interest rate, the term, the face amount of each bond that is a part of the issue, and the amount of lendable proceeds from the issue;

(2) the name of the elected official or legislative body that approved the issue or a description of the voter referendum, if any;

(3) the name, address, and tax identification number of each initial substantial user (within the meaning of Treas. Reg. § 1.103–11(b)) of any facilities financed with the proceeds of the issue; and

(4) a description of the property, facility, or project for which the proceeds are to be used.

The committee intends that the property financed by the bonds be identified in the quarterly report on an asset-by-asset basis (by cost recovery class, if any) and by a general description of the facility or project. Unless there is substantial compliance with this requirement, interest on the obligations is not tax-exempt. The IRS is authorized to extend the time for filing these reports for reasonable cause. The committee anticipates that the IRS will make compilations and summaries of the information reported available to Congress and will become a matter of public record at that time.

Public hearing and approval or voter referendum requirements

The committee bill establishes new approval requirements for issuers of IDBs.[2] Failure to comply with these requirements will result in loss of tax exemption for the interest on the bonds. The new requirements are twofold: (1) reasonable notice must be given and a public hearing held and (2) issuance of the bonds must be approved after the hearing by an elected public official or elected legislative body. Each requirement is intended to operate independently of existing or future State law requirements although, in many instances, existing or future procedures provided for by State law may satisfy the new Federal requirements. Alternatively, a voter referendum, held at such time and in such manner as referenda on other issues affecting government spending under applicable State and local law, may be used in place of the hearing and elected representatives approval requirements.

Notice and hearing

If the voter referendum alternative is not used, the bill requires that a public hearing be held by the issuer of all tax-exempt IDBs and by each other governmental unit in which any facility with respect to which bond proceeds are to be used is to be located. In the case of multiple governmental units within a State having concurrent jurisdiction over the geographic area of the location of the facility, only the issuer and one of the units having such jurisdiction over the area where the facilities are located are required to hold public hearings. The hearing must be held before the approval of the bonds.

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[2] Since this restriction only applies to IDBs, it generally does not apply to student loan bonds or bonds for tax-exempt organizations (described in section 501(c)(3)).

The hearing must be preceded by published notice reasonably designed to apprise residents of the affected governmental units of the proposed issuance of the bonds. The committee anticipates that such notice generally will be published no less than 14 days before the scheduled date of the hearing. The hearing should be conducted in a manner that provides a reasonable opportunity for persons with differing views on both issuance of the bonds and the location and nature of the proposed facility to be heard. It is not necessary that the elected official who will approve the bonds be present at the hearing or that a report on the hearing be submitted to that official although it is contemplated that an issuer may wish to take these steps to better inform the decision of the elected representative required to approve the bonds. In addition, the committee does not intend that this requirement automatically invoke any State administrative procedural requirements as to hearings in general.

Approval by elected representative

Following the public hearing and prior to issuance of the bonds, the applicable elected representative of each governmental unit holding the required hearing, must approve issuance of the bonds.[3] The amendment provides that the applicable elected representative is generally to be the chief executive of the governmental unit or an elected legislative body (e.g., city council, etc.).[4] If multiple legislative bodies have authority over issuance of bonds in a jurisdiction, the body with more specific authority must approve their issuance. For example, if an elected board of directors of an industrial development authority and an elected city council are both authorized to approve issuance of IDBs, IDBs related to industrial development would be approved by the board of directors of the industrial development authority rather than the city council. However, if the board of directors of the industrial development bond authority is not elected, then the elected city council must approve the bonds regardless of whether the board is authorized to issue IDBs. Special rules are included permitting designation by the applicable elected representative otherwise required to approve bond issues of another elected representative to approve bond issues. In no case, however, can the approval be by an individual or body not elected by the residents of the effected governmental unit. If there are no elected officials or elected legislative bodies for a governmental unit, the approval requirement must be met by an appropriate elected official for the next higher level of government that has an elected official or an elected legislative body and from which the lower government derives its authority.

Exception for certain subsequent and refunding issues

Under the committee bill, a public hearing and approval by an authorized elected representative is not required for certain issues solely to refund a prior issue, provided the original issue was approved by the appropriate elected official following such a hearing. This exception does not apply, however, in the case of refunding bonds that will mature after the date on which the bonds to be refunded would have matured.

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[3] The approval of an appropriate elected representative required by the bill may occur before or after the governmental unit commits itself to issue the bonds. Consequently, the approval requirement does not affect the present law rule that an inducement resolution be approved prior to commencement of construction in certain cases; however, the jurisdiction cannot bind itself to exercise the approval required by the bill prior to the hearing.

[4] In the case of a bicameral legislative body, the required approval must be by both chambers of the body.

The public hearing and approval requirements also do not apply to certain subsequent issues by the same governmental unit for a facility when the subsequent issues occur within 3 years of the initial issue date of an approved issue. This exception permits issuers to approve up to a 3-year plan of financing for a facility while satisfying the public hearing and approval requirements once, either prior to or at the time of the initial issue. For example, an issuer could approve financing for a facility with a specified amount of IDBs to issue as different phases of construction occur. In such a case, provided the funds are all used for the same facility and all obligations are issued within a 3-year period pursuant to the plan of financing, only one public hearing and approval by an elected representative is required. This exception will not apply, however, to IDBs issued to finance different facilities or not issued pursuant to a single plan of financing even when the facilities are owned or used by the same party (or a related party).

Restriction of cost recovery deduction for certain property financed with tax-exempt bonds

General rule

The committee bill provides that property that is placed in service[5] after December 31, 1982, generally is not eligible for cost recovery deductions under ACRS or other accelerated cost recovery provisions of the Code, to the extent that the facilities are financed by any tax-exempt bonds.[6] In lieu of deductions under ACRS, the cost of property financed with IDBs must be recovered using the straight-line method (with a half-year convention for personal property and a monthly convention for real property) over the following schedule of lives; 5 years for 3-year property, 8 years for 5-year property, 15 years for 10-year property, 22 years for 15-year public utility property, 15 years for 15-year residential real property, and 25 years for nonresidential 15-year real property. This limitation applies to both the first owner of the property and to any subsequent owners who acquire the property while the IDBs (including any refunding issues) are outstanding.

Exceptions for certain facilities

The bill includes several exceptions permitting the cost of certain types of facilities financed in whole or in part with IDBs to continue to be recovered under ACRS: low income rental housing, municipal solid waste disposal facilities, certain new air or water pollution control facilities, and certain facilities for which UDAG grant is made.

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[5] For this purpose, property is placed in service when it is eligible for investment credit and capital cost recovery deductions.

[6] If the tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for that property in prior years.

Low-income rental housing, which will continue to qualify for both tax-exempt financing and ACRS, is any residential rental property that is described in section 103(b)(4)(A).

Municipal solid waste disposal facilities, which will continue to qualify for both tax-exempt financing and ACRS, are any solid waste disposal facility which is financed with obligations the interest on which is exempt pursuant to section 103(b)(4)(E) where substantially all of the solid waste (other than recycled waste) processed by the facility is collected from the general public.

The air or water pollution control facilities, which will continue to qualify for ACRS deductions and tax-exempt financing, are air or water pollution control facilities which are financed with obligations the interest on which is exempt under section 103(b)(4)(F) and which are used in connection with a plant or other property in operation before July 1, 1982. In addition, air or water pollution control facilities used in connection with conversion of oil- or gas-fired facilities to coal will be permitted cost recovery deductions under ACRS, but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982. For example, installation of a new coal furnace after July 1, 1982, will not disqualify related pollution control equipment from ACRS deductions if the replaced oil- or gas-fired furnace was in operation at the facility as of July 1, 1982.

Finally, facilities financed with tax-exempt bonds, which are eligible for the exclusion of $10 million of capital expenditures because the facilities benefit from a UDAG grant, will continue to be permitted ACRS deductions. This exception will not apply unless the amount of the UDAG grant equals or exceeds 5 percent of the total capital expenditures on the facility. In the case of property partially financed by a UDAG grant that benefits multiple facilities, only an allocable share of the grant is used in determining whether this capital expenditure test is satisfied for any individual facility.

Limitation on single issues including "clean limit" small issue IDB's and other tax-exempt bonds

The committee bill provides that the $1 million "clean limit" small issue exception (sec. 103(b)(6)(A)) is not available for any IDBs issued as part of a single issue with any other obligations, the interest on which is tax-exempt under any provision other than the small issue exception. For example, under the bill, if $21 million of IDBs were issued in connection with an airport facility where the interest on $20 million of the bonds was exempt under the exempt purpose exception for airports (sec. 103(b)(4)(D))[7] and the remaining $1 million of bonds were used to finance a non-exempt function facility, the interest on the bonds would not be exempt. Small issue IBDs issued under the alternative $10 million "capital expenditures" limitation (sec. 103(b)(3)(D)) will continue to be eligible for tax exemption if issued as part of a combined issue but only if the issuer elects to qualify the small issue IDBs for tax-exemption under that alternative limitation.

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[7] This amount includes the so-called "insubstantial portion" of the proceeds which need not be used for the exempt function facilities.

Sunset of small issue exception

Under the committee bill, the small issue exception (sec. 103(b)(6)) is repealed with respect to obligations (including refunding obligations) issued after December 31, 1985.

Effective Dates

General rule

These provisions of the bill apply generally to obligations issued after December 31, 1982, including obligations issued solely to refund obligations outstanding on or before that date.

Composite issues and "clean limit"

The provisions of the bill allowing certain composite-issue IDBs and restricting "clean issue" small issue IDBs apply to bonds issued after the date of enactment.

Public hearing and approval

The public hearing and approval requirement applies to obligations, including refunding issues, issued after December 31, 1982, but not to issues solely to refund obligations issued in conformity with the hearing and approval requirement, if the refunding issue matures no later than the maturity date of the original issue.

Restriction on cost recovery deductions

The restriction on the availability of accelerated cost recovery deductions for property with respect to which tax-exempt financing is provided applies generally to all such property placed in service after December 31, 1982.

The restrictions on cost recovery deductions do not apply to a facility placed in service after December 31, 1982, if either

(1) construction of the facility had commenced before July 1, 1982, or

(2) a binding contract existed on July 1, 1982, and at all times thereafter, which committed the purchaser to incur significant expenditures for construction or acquisition of the facility.

For purposes of this exception, whether expenditures are significant may be determined by comparing the amount of the expenditures to the total anticipated cost of the facility.

Whether or not an arrangement between a taxpayer and a purchaser and contractor or seller constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to exist on July 1, 1982, however, unless the property to be acquired or services to be rendered are specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services which the taxpayer is obligated to pay for under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items he must purchase.

A contract may be considered binding on the taxpayer even though (a) the price of the item to be acquired or services rendered under the contract is to be determined at a later date, (b) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

On the other hand, a contract which is binding on a taxpayer on July 1, 1982, will not be considered binding at all times thereafter if it is substantially modified after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

The restrictions on cost recovery deductions also do not apply to property placed in service after December 31, 1982, to the extent that the property is financed with tax-exempt bonds issued before July 1, 1982. For purposes of this exception, a refunding issue issued after June 30, 1982, generally is treated as a new issue and the taxpayer must use the slower recovery methods and periods for unrecovered cost from the date of the refunding issue. If significant expenditures are incurred in respect of the facility before January 1, 1983, however, a refunding issue will not be treated as a new issue and the accelerated cost recovery methods and periods may continue to be used. As with the exception for certain binding contracts, discussed above, whether expenditures are significant for purposes of this exception may be determined by comparing the amount of the expenditures to the total anticipated cost of the facility.

In cases where a change of recovery method and period is required, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon the refunding of a pre-July 1, 1982 issue where no significant expenditures are made with respect to the facility before January 1, 1983. For example, if in Year 4 a taxpayer refunds bonds financing 5-year ACRS property having an unrecovered basis of $50,000 at the time of refunding, the $50,000 must be recovered using the straight-line method over the 4 remaining years of the 8-year extended recovery period for 5-year ACRS property.

b. Other amendments affecting industrial development bonds

(1) Tax exemption for industrial development bonds for facilities for the local furnishing of gas (sec. 224 of the bill and sec. 103(b)(4) of the Code)

Present Law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide certain exempt activity facilities. Such facilities include facilities for the local furnishing of electric energy and gas (sec. 103(b)(4)(E)).

A facility for the local furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. § 1.103–8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include also property for the furnishing of electric energy which is part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Reasons for Change

The committee concluded that the same reasons that the Congress had in 1978 for extending the local furnishing of electricity to a service area consisting of no more than a city and a contiguous county also apply in the case of the local furnishing of gas.

Explanation of Provision

The bill provides that local furnishing of gas from a facility includes the furnishing solely within an area comprised of a city and one contiguous county. Thus, under the bill, tax-exempt financing is made available in the case of a facility for the furnishing of gas (which otherwise meets the requirements of sec. 103) provided that the service area of the facility comprises no more than two contiguous counties or a city and one contiguous county.

Effective Date

This provision applies to obligations issued after the date of enactment.

(2) *Industrial development bonds for local district heating or cooling facilities (sec. 224 of the bill and new sec. 103(b)(4)(J) of the Code)*

Present Law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

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A facility for the furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. § 1.103–8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to also include property for the furnishing of electric energy which is part of a system which provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.[8]

Reasons for Change

The committee believes that facilities that provide for local distribution of energy for heating and cooling through steam or water from a central energy source should be encouraged. In many respects, these facilities are analogous to facilities which provide for the local furnishing of electric energy or gas. Accordingly, the committee concludes that tax-exempt IDBs should be available to finance the facilities that distribute energy for heating or cooling in the form of water or steam on a local basis.

Explanation of Provision

The bill exempts from tax interest on IBDs issued to finance local heating or cooling facilities.

A local district heating or cooling facility includes equipment and other property used as an integral part of a local heating or cooling system, including pipes and piping, pipe insulation, valves, pumps, expansion systems, heat exchangers, temperature controls, terminal units and meters, whether used by the producer, distributor, or consumer of local heating or cooling. The bill does not cover the facilities which produce the hot water, chilled water or steam or facilities that are owned for tax purposes by a consumer. A local heating or cooling system is any system consisting of a pipeline or network, which may include or be connected to a heating or cooling source, which provides hot water, chilled water, or steam or two or more users for residential, commercial, or industrial heating or cooling, or process steam, or for any combination of such purposes. For this purpose, heating or cooling system is considered local if it has a service area comprised of no more than two contiguous counties or a city and one contiguous county.

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[8] Section 224 of the committee extends this rule to property for the local furnishing of gas.

Effective Date

This provision applies to obligations issued after the date of enactment.

(3) Exemption for certain multiple lot issues of industrial development bonds (sec. 221 of the bill and sec. 103(b)(6) of the Code)

Present Law

Under present law, gross income does not include interest on obligations of a State or a political subdivision of a State (sec. 103(a)(1)). This exclusion does not apply, however, to interest on industrial development bonds unless the bonds fall within certain exceptions (sec. 103(b)). One of these exceptions provides that an exemption for interest on such bonds which are part of an issue with a face amount of $1 million or less,[8] substantially all of the proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or depreciable property (referred to as small issue bonds), is exempt.

In certain cases, pooled offerings of bonds having an aggregate face value in excess of $1 million have been marketed as a single unit by the issuing authority or authorities. The pooled offerings have attributes of both a single bond issue and of a multiple lot of single bond issues. If viewed as a single bond issue, the bonds generally do not qualify for the small issue exception, and the interest paid on them is not, therefore, exempt from Federal income taxation.

In Revenue Ruling 81-216,[9] the Internal Revenue Service issued guidelines for determining whether a pooled offering of bonds is treated as a single bond issue or as a multiple lot issue. Under the ruling, this determination is stated to be factual, but such a pooled offering is generally treated as a single bond issue if the following factors are present:

(1) the bonds are sold at substantially the same time;

(2) the bonds are sold pursuant to a common plan of marketing;

(3) the bonds are sold at substantially the same rate of interest; and

(4) a common or pooled security is used or is available to pay debt service on the bonds.

On October 8, 1981, the Internal Revenue Service proposed regulations that provided essentially the same rules as Rev. Rul. 81-216 and proposed to revoke that revenue ruling.[10]

Reasons for Change

The committee believes that businesses should be able to obtain the cost savings of issuing tax-exempt small issue IDBs in multiple lots with small issue IDBs to be used by other unrelated businesses. However, the committee believes that multiple lot tax-exempt small issue IDB's should not be permitted if (1) the bonds finance facilities located in more than one State, (2) the bonds are financing more than one facility for any principal user of facilities or (3) where a single company is obtaining the benefit of such bonds indirectly as a franchisor.

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[8] A $10 million limit applies if the issuer elects; however, in such cases certain capital expenditures over a 6-year period are considered in determining whether the $10 million limit is exceeded.

[9] 1981-36 I.R.B. 6 (September 8, 1981).

[10] 46 Fed. Reg., 50014 (October 8, 1981.)

Explanation of Provision

The bill provides that multiple lots of obligations will be treated as part of the same issue only if the proceeds of the obligations are to be used to finance facilities which are located in more than one State or have the same principal users or principal users that are related persons. For this purpose, a principal user includes a person (other than a governmental unit) which (1) either guarantees directly or indirectly the repayment of obligations or aids in arranging the issuance of the obligations and (2) provides a property, franchise, trademark, or trade name to be used in connection with the facilities financed with the obligations. Whether obligations meet any of these tests is to be determined under the facts and expected uses as of the date that the obligations are issued. Thus, interest on obligations which originally did not meet any of these tests will not lose their exemption because facilities financed by the obligations are moved out of the State or because principal users of two facilities financed by the obligations subsequently become related, so long as these events were not expected at the time of the issuance of the bonds.

Effective Date

The provision is effective for obligations issued after the date of enactment.

(4) Exclusion of certain research expenses from capital expenditure limitation for small issue industrial development bonds (sec. 221 of the bill and sec. 103(b)(6) of the Code)

Present Law

Interest on certain "small issue" industrial development bonds is exempt from Federal income tax if the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of the proceeds of an exempt small issue) made over a six-year period does not exceed $10 million (sec. 103(b)(6)).

Under present law, research or experimental expenditures incurred in connection with a taxpayer's trade or business may be taken into account for purposes of determining if the small issue limitation of $10 million is exceeded, whether or not the taxpayer elects (under sec. 174(a)) to deduct currently such research expenses.

Reasons for Change

The committee believes that research and development expenditures should be encouraged. The present law rule that requires research and development expenditures to be counted in meeting the $10 million limitation may provide a substantial impediment to firms using small issue IDBs and incurring certain research and development costs. Consequently, the committee believes that research and development expenditures of a type for which the credit for research and development may be allowable should not be counted in determining whether the $10 million capital expenditure limitation is met. Moreover, the committee believes that such a rule is consistent with the purpose of the $10 million limitation of restricting the size of projects which may be financed with small issue bonds because the size of a project is not affected by the amount of research and development expenses for supplies and salaries.

Explanation of Provision

Under the bill, expenditures for research wages or for research supplies (as defined in secs. 44F(b)(2)(A)(i) or (ii)) which the taxpayer elects to deduct currently (under sec. 174(a)) are not taken into account for purposes of the $10 million capital expenditure limitation on tax-exempt small issue industrial development bonds.

Effective Date

The provision applies to research wage and supply expenditures made after the date of enactment.

c. Amendments to the Mortgage Subsidy Bond Tax Act (sec. 203 of the bill and sec. 103A of the Code)

Present Law

In general

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (Pub. L. 96-499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing.

Three-year requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages financed from the bond proceeds must be provided to mortgagors each of whom did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date that the mortgage is executed.

The three-year requirement does not apply with respect to mortgagors of residences in three situations. First, it does not apply to mortgagors of residences that are located in a targeted area. Second, it does not apply to mortgagors who receive qualified home improvement loans. Third, it does not apply to mortgagors who receive a qualified rehabilitation loan.

Purchase price requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, must be for the purchase of residences where the acquisition cost of each residence does not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence.

Arbitrage

Mortgage investments

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments.

Under the Act, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than one percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than one percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments

The Act also imposes restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve of one and one half times the maximum annual scheduled debt service. The Act provides that the reserve must be reduced as future annual debt service is reduced.

The Act also limits the amount that may be invested as unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year. An exception to the 150-percent debt service rule is provided, however, for proceeds invested for an initial temporary period until such proceeds are needed for mortgages.

Present law also requires that arbitrage earned by the issuer on nonmortgage investments is to be paid or credited to the mortgagors or paid to the Federal Government. While the arbitrage rules do not explicitly so indicate, they appear to contemplate that the arbitrage rules relating to rebating are to be applied on an issue-by-issue basis.

Reasons for Change

The committee is concerned over the present distressed state of the housing industry. In light of the fact that the mortgage subsidy bond program is scheduled to terminate on December 31, 1983, the committee believes that relaxation of some of the limitations in the Mortgage Subsidy Bond Tax Act of 1980 is the most effective and least costly method of providing temporary aid to that industry. Relaxation of the arbitrage limitation, 3-year requirement, and purchase price requirement should ensure that the volume of mortgage subsidy bonds will increase toward the maximum volume restrictions of present law.

The committee provides these changes from present law because of the temporily distressed state of the housing industry, even though the changes might reduce the effect of the restrictions of the Mortgage Subsidy Bond Tax Act to target the benefits of tax-exempt bonds to persons of the greatest need. Nonetheless, the committee expects that State and local issuers will exercise their discretion in the use of mortgage subsidy bonds so as to implement the basic purposes of the Mortgage Subsidy Bond Tax Act as much as practicable.

Explanation of Provision

3-year requirement

The bill modifies the 3-year requirement of present law to provide that at least 80 percent of the lendable proceeds (i.e., bond proceeds less issuance expenses and reserves) of the issue must be loaned to mortgagors who meet the 3-year requirement of present law. The 80-percent test is to be computed by excluding any financing with respect to targeted area residences, any qualified home improvement loan, and any qualified rehabilitation loan.

Purchase price requirement

The bill increases the purchase price requirement from 90 percent (110 percent in targeted areas) of the average area purchase price to 110 percent (120 percent in targeted areas).

Arbitrage limitations on mortgage investments

The bill would replace the 1.0 percentage point limitation of present law with a limit which varies with the size of the issue, beginning at one and one-sixteenth (1¹⁄₁₆) percentage points but not to exceed one and one-eighth (1⅛) percentage points. The limitation is 1.0625 percentage points plus 0.01 percentage point (not to exceed 1.125 percentage points) for each $10 million that the aggregate face amount of the issue is less than $100 million. The one and one-eighth (1⅛) percentage point limit is, therefore, reached with a $30 million issue. For the purpose of determining the amount of allowable arbitrage, an issue means any bonds that are sold at substantially the same time pursuant to a common plan of marketing at substantially the same interest rates.

Loss on reserve liquidations

The bill provides that the rule requiring liquidation of nonmortgage investments with a yield higher than the issue yield will not apply to the extent that it would require disposition of any nonmortgage investment resulting in a loss in excess of the amount which could be earned from investments in qualified mortgages. However, the rule will continue to apply if the sale of such nonmortgage investments would not result in a loss when the investments are sold to meet the liquidation rule. Similarly, the rule will apply if loss assets subsequently appreciate so that their sale or exchange would not result in a loss.

Effective Dates

Except for the modifications to the 3-year requirement, the provisions are effective for bonds issued after the date of enactment. The modification to the 3-year requirement is effective for bonds issued after April 24, 1979, to the extent that proceeds have not been committed to mortgagors by date of enactment.

d. Revenue effect of tax exempt bond provisions

It is estimated that the tax-exempt bond provisions will increase budget receipts by $84 million in fiscal year 1983, $384 million in 1984, $789 million in 1985, $1,381 million in 1986, and $2,236 million in 1987.

9. Mergers and Acquisitions

a. Partial liquidations (sec. 226 of the bill and secs. 331, 336, and 346 of the Code)

Present Law

A distribution in redemption of a corporation's stock pursuant to a plan is a partial liquidation if it is one of a series of distributions in redemption of all the stock or it is not essentially equivalent to a dividend and occurs within the taxable year in which the plan is adopted or the succeeding year (sec. 346(a)).

In determining that a distribution is not essentially equivalent to a dividend in applying the tests for a partial liquidation, generally a contraction of the corporation's business is required. A distribution may constitute a partial liquidation even though it is made pro rata among the corporation's shareholders.

If the distribution consists of the assets of, or is attributable to the corporation's ceasing to conduct, a trade or business conducted for 5 years or more before the distribution and was not, within the 5-year period, acquired by the corporation in a taxable transaction and the corporation, after the distribution, continues to conduct another trade or business with a similar history, the distribution is treated as a partial liquidation (sec. 346(b)).

No gain or loss to the distributing corporation is recognized on a distribution in a partial liquidation (sec. 336(a)). Exceptions are provided for disposition of installment obligations and distributions of LIFO inventory. In addition, the various recapture rules of present law override sec. 336. If, however, the corporation, rather than distributing assets, sells the assets and distributes the proceeds to its shareholders in a partial liquidation, gain or loss is recognized to the corporation on the sale.

Shareholders receiving a distribution in partial liquidation are treated as receiving the amount distributed in exchange for their stock and, if the stock redeemed in the transaction is a capital asset to the shareholder, capital gain or loss results from the transaction. The basis of any assets received in a partial liquidation is their fair market value at the time of the distribution.

Reasons for Change

The current treatment of partial liquidations affords the possibility of capital gain treatment to shareholders and a stepped-up basis for distributed assets in transactions that, in some cases, are not readily distinguishable from dividends. A distribution, even though it accomplishes a corporate contraction, resembles a dividend and should be classified as a dividend if there are sufficient earnings and profits, the distribution is pro rata among the shareholders, and the corporation continues to carry on a trade or business.

The partial liquidation rules allow unwarranted selectivity when one corporation has acquired control of another. A stepped-up basis for selected assets with little or no tax consequences can be combined with a continuation of the acquired entity, provided a distribution of the selected assets satisfies the corporate contraction standard. If the acquiring and acquired corporations file a consolidated return, recapture items are deferred under the current consolidated return regulations and investment tax credit recapture rules do not apply.

The committee believes there should be no difference between a sale by a corporation of its assets and a distribution of the proceeds to shareholders in exchange for their stock (a transaction that results in recognition to a corporation not in the process of completely liquidating of any gain on the sale whether or not a partial liquidation) and a transfer by a corporation of its assets to shareholders in exchange for their stock.

Under the present rules, a partial liquidation may consist of the distribution of a trade or business to noncorporate shareholders who wish to conduct it as an individual enterprise or as a partnership while retaining a separate trade or business in corporate form. The committee believes that the retention of a rule permitting capital gain treatment at the shareholder level in this limited class of cases will preserve this option. However, in this as in other cases covered by the bill, the committee believes that where a redemption of stock for property involves a continuing corporation and is treated as a taxable exchange by the shareholders, it should be treated as a taxable exchange by the corporation.

Explanation of Provision

The bill repeals the provisions of existing law defining partial liquidations and the rules governing the treatment of both shareholders and the distributing corporation on such transactions. The treatment of such distributions will be determined by the provisions of present law as amended by the bill governing nonliquidating distributions by corporations.

Distributions consisting of the assets of, or attributable to the corporation's ceasing to conduct, a trade or business and constituting a partial liquidation under section 346(b) of present law will qualify as distributions not essentially equivalent to a dividend when made to noncorporate shareholders, resulting in sale or exchange treatment under section 302(a) even though the distribution is made pro rata to the shareholders. Distributions qualifying under this provision would be the only transactions where the effect on the distributing corporation is relevant in determining that a stock redemption is not essentially equivalent to a dividend.

A distribution that is one of a series in redemption of all the stock of a corporation, defined as a partial liquidation in present law, is defined as a complete liquidation under the bill.

The bill authorizes the Secretary of the Treasury to prescribe regulations, where necessary, to ensure that repeal of the provisions providing special treatment of partial liquidations will not be circumvented through the use of other provisions of present law or regulations, including the consolidated return regulations. It is contemplated that such regulations may treat a corporation as continuing and characterize any distribution accordingly where a transaction is in form a complete liquidation but business operations are continued in corporate solution as a result of a spin-off or other tax-free transfer by the liquidating corporation. For example, a corporation may transfer to a newly-formed subsidiary corporation a trade or business and distribute the stock of such corporation to its shareholders in a transaction qualifying for nonrecognition of gain under section 355. If there is a subsequent distribution of a retained trade or business and all its other properties by the distributing corporation, such regulations may treat the subsidiary corporation as a continuation of the distributor and the distribution by the latter of all its properties other than those contributed to the subsidiary corporation as a distribution other than a distribution in complete liquidation.

The bill does not affect the treatment under present law of any distribution which may in substance constitute a sale of assets.

Effective Date

This provision of the bill applies generally to distributions made after August 31, 1982. However, if a majority of the shares in a corporation were acquired either pursuant to a tender offer outstanding on July 1, 1982, or under a binding contract entered into on or before July 1, 1982, and a plan of liquidation was adopted by such corporation on or before October 1, 1982, this provision will not apply to any distribution pursuant to such plan.

b. Certain distributions of appreciated property (sec. 227 of the bill and sec. 311(d) of the Code)

Present Law

When a corporation in a nonliquidating distribution distributes property, the value of which exceeds its basis, in redemption of a portion of the corporation's stock, gain is recognized as though the property were sold (sec. 311(d)(1)). Present law excepts several types of transactions from this requirement.

Exceptions are provided for (1) distributions that terminate the interest of a shareholder who has held at least 10 percent of the corporation's stock for a 12-month period; (2) distributions that consist of stock or obligations in a subsidiary conducting a trade or business that was at least 50 percent owned by the distributing corporation at any time within the preceding 9 years; (3) distributions that consist of stock or securities distributed pursuant to certain anti-trust decrees; (4) distributions to which section 303(a) (relating to distributions in redemptions of stock to pay death taxes) applies; (5) certain distributions to private foundations; (6) certain distributions by regulated investment companies; and (7) certain distributions pursuant to the Bank Holding Company Act.

Nothwithstanding these exceptions, present law may permit a transaction that is in form a stock redemption to be treated as a direct sale of assets where the stock ownership is transitory. Where stock in a corporation is purchased and thereafter pursuant to plan redeemed for property of the corporation, the Internal Revenue Service treats the transaction under present law as a direct purchase of the property, resulting in the recognition of gain or loss to the corporation (see Rev. Rul. 80-221, 1980-2 C.B. p. 107).

Reasons for Change

A direct sale of property by a corporation and a distribution of property in a stock redemption may be economically equivalent events whether or not the ownership of the stock is transitory. Accordingly, the committee believes that these transactions should be treated symmetrically.

The committee also believes that certain exceptions to the rule that a corporation recognizes gain when it distributes appreciated property in a stock redemption place an unwarranted premium on making an acquisition through a purchase and subsequent redemption of stock in exchange for the desired property. The committee believes that generally such distributions should be treated as taxable exchanges by the corporation.

At the time Congress enacted section 311(d)(1) and the exceptions thereto, the Conference Committee requested the Treasury Department and Congressional staffs to analyze the provision to see whether any tax avoidance possibilities still remain. The committee believes that the existence of certain of the exceptions result in avoidance possibilities.

Elimination of the unwarranted exceptions in section 311(d)(2) combined with repeal of the special treatment for partial liquidations will result generally in the recognition of gain to a continuing corporation when it distributes appreciated property in redemption of its stock.

Explanation of Provision

The bill repeals the exceptions in section 311(d)(2) for distributions terminating the interest of a shareholder who has held 10 percent or more of the corporation's stock for one year, for distributions of stock or obligations of a subsidiary, for distributions pursuant to antitrust decrees, and for distributions pursuant to the Bank Holding Company Act.

The bill is not intended to affect the treatment under present law of distributions that are in substance the purchase of assets.

Effective Date

This provision of the bill applies to distributions made after August 31, 1982.

c. Stock purchases treated as asset purchases (sec. 229 of the bill and sec. 338 of the Code)

Present Law

Upon the complete liquidation of a subsidiary corporation, 80 percent of the voting power and 80 percent of the total number of shares of all other classes of stock (other than nonvoting preferred stock) of which is owned by the parent corporation, generally gain or loss is not recognized and the basis of the subsidiary's assets and the other tax attributes are carried over (secs. 332, 334(b)(1), and 381(a)).

If the controlling stock interest was acquired by purchase within a 12-month period and the subsidiary is liquidated pursuant to a plan of liquidation adopted within 2 years after the qualifying stock purchase is completed, the transaction is treated as in substance a purchase of the subsidiary's assets (sec. 334(b)(2)). The acquiring corporation's basis in the "purchased" assets is the cost of the stock purchased as adjusted for items such as liabilities assumed, certain cash or dividend distributions to the acquiring corporation, and postacquisition earnings and profits of the subsidiary. The liquidating distributions can be made over a 3-year period beginning with the close of the taxable year during which the first of a series of distributions occurs (sec. 332(b)(3)). Thus, this treatment applies even though the liquidation can extend over a 5-year period after control has been acquired.

In these cases, when the assets are treated as purchased by the acquiring corporation, recapture income is taxed to the liquidating corporation, the investment tax credit recapture provisions are applicable, and tax attributes, including carryovers, of the liquidated corporation are terminated.

Cases interpreting the law applicable before the rules in section 334(b)(2) were adopted treated the purchase of stock and prompt liquidation in some cases as a purchase of assets *(Kimbell-Diamond Milling Co.* v. *Commissioner* 14 T.C. 74, aff'd per curiam, 187 F2 718 (5th Cir.) cert. denied, 342 US 827 (1951)). It is not clear whether such treatment may still apply in some cases where the requirements of section 334(b)(2) are not met.

A stock purchase and liquidation is treated as a purchase of all the assets of the acquired corporation under present law if section 334(b)(2) applies. Elimination of the special treatment of partial liquidations under the bill restricts the options of a corporate purchaser seeking to treat a purchase of a corporation as a purchase of assets in part combined with a continuation of the tax attributes of the acquired entity. Present law does not restrict a corporate purchaser from achieving such selectivity by purchasing assets directly from a corporation while concurrently purchasing the corporation's stock. Selectivity can also be achieved if an acquired corporation, prior to the acquisition, disperses its assets in tax-free transactions among several corporations which can be separately purchased. The corporate purchaser then through selective qualifying liquidations can obtain asset purchase treatment for one or more acquired corporations while preserving the tax attributes of one or more other corporations.

Reasons for Change

While section 334(b)(2) does not permit selectivity within the context of a single corporation in that the transaction is treated as wholly an asset purchase or wholly a stock purchase, inconsistency is inherent in permitting a continuation of the acquired corporation's tax attributes for up to 5 years after a stock purchase while also treating the transaction as though assets had been purchased.

If consolidated returns are filed by the acquiring corporation, the tax attributes of the acquired corporation (including carryovers, subject to certain limitations in the Code and the consolidated return regulations) are reflected on such returns for the period prior to its complete liquidation. Recapture income triggered by liquidating distributions may be offset by losses of other members of the consolidated return group, a result not available when assets are directly purchased.

Whether or not a consolidated return is filed, the extended period that may elapse between stock purchase and liquidation requires complex adjustments for earnings or deficits of the acquired corporation during the intervening period as well as for sales of assets and other items during such period in order to properly allocate the cost of the stock to the assets upon their ultimate distribution. Existing case law permits a stepped-up basis for assets distributed in liquidation that in some cases exceeds the cost basis that would be applicable if the assets were purchased directly by the controlling corporation. See, *R.M. Smith, Inc.*, 69 TC 317 (1977).

Present law also provides unwarranted tax motivations for structuring a corporate acquisition as in part a purchase of assets and in part a purchase of stock or as a purchase of several corporations historically operated as a unit in order to preserve selectivity of tax treatment. These motivations include the ability to achieve a stepped-up basis for some assets while avoiding recapture tax and other unfavorable tax attributes with respect to other assets.

Explanation of Provisions

General revision of stock purchase as asset purchase

The bill repeals the provision of present law (sec. 334(b)(2)) that treats a purchase and liquidation of a subsidiary as an asset purchase. The bill is also intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine. Instead, an acquiring corporation, within 75 days after a qualified stock purchase, may elect to treat an acquired subsidiary (target corporation) as if it sold all its assets in a complete liquidation on the stock acquisition date. The target corporation will be treated as a new corporation that purchased the assets on such date. Gain or loss will not be recognized to the same extent gain or loss is not recognized under present law (sec. 337) when a corporation sells all its assets in the course of a complete liquidation.

A qualified stock purchase occurs if 80 percent or more of the voting power and 80 percent of the total number of shares of other classes of stock (except nonvoting, preferred stock) is acquired by purchase during a 12-month period (the acquisition period). The acquisition date is the date within such acquisition period on which the 80-percent purchase requirement (the qualified stock purchase) is satisfied.

The election is to be made in the manner prescribed by regulations and, once made, will be irrevocable.

Treatment of target corporation as new corporation

The assets of the target corporation will be treated as sold (and purchased) for an amount equal to the basis of the acquiring corporation in the stock of the target corporation on the acquisition date or, if the basis is greater on such date, on the last day of the 12-month acquisition period. The amount is to be adjusted under regulations for liabilities of the target corporation and other relevant items. It is anticipated that recapture tax liability of the target corporation attributable to the deemed sale of its assets is an item which may result in an adjustment under the regulations.

The target corporation is treated as a 'new' corporation after the acquisition date for all purposes relating to its tax liability either as the selling or purchasing corporation. Its taxable year as the selling corporation ends on the date of acquisition and it does not become a member of the affiliated group including the acquiring corporation until the day following the date of acquisition. However, it is not intended that any minority shareholders in the target corporation shall be treated as having exchanged stock in the selling corporation for stock in the purchasing corporation. Further, additional purchases of the target corporation's stock by the acquiring corporation after the acquisition date are to be treated as purchases of the stock of the selling corporation if made on or before the close of the acquisition period.

The basis of the acquiring corporation in the target corporation's stock may be affected by transactions other than additional stock purchases after the acquisition date and on or before the close of the acquisition period, such as contributions to the target corporation or earnings of the target corporation reflected in the acquiring corporation's basis for its stock under the consolidated return regulations. These transactions represent basis increases in the stock of the 'new' corporation and will not be taken into account in determining the amount for which the target corporation's assets are treated as sold.

Treatment of recapture items

Under the elective treatment provided by the bill, any recapture income of the target corporation attributable to the deemed sale of its assets is not to be included in any consolidated return of the acquiring corporation. The target corporation will not become a member of the acquiring corporation's affiliated group until the day following the date of acquisition. Recapture items of the target corporation will normally be associated with the final return of the target corporation (as the selling corporation) ending on the date of acquisition.

In some cases, recapture items may be includible in income for a period during which the target corporation is included in a consolidated return of the acquiring corporation. Where, for example, there is an adjustment to the purchase price for its stock based on post-acquisition date earnings of the target corporation, there may be additional amounts of recapture income. Such additional income is to be separately accounted for and may not be absorbed by losses or deductions of other members of the acquiring corporation's affiliated group.

Definition of purchase

The term "purchase" is defined as it is under present law (sec. 334(b)(3)) to exclude acquisitions of stock with a carryover basis or from a decedent, acquisitions in an exchange to which section 351 applies, and acquisitions from a person whose ownership is attributed to the acquiring person under section 318(a). Attribution under section 318(a)(4) relating to options will be disregarded for this purpose. However, if, as a result of a stock purchase, the purchasing corporation is treated under section 318(a) as owning stock in a third corporation, the purchasing corporation will be treated as having purchased stock in such third corporation but not until the first day on which ownership of such stock is considered as owned by the purchasing corporation under section 318(a). This rule may be illustrated by the following example:

Assume a target corporation and a third corporation each have only one class of stock outstanding and that the target corporation owns 50 percent of the stock of the third corporation. The purchasing corporation purchases 20 percent of the target corporation on each of five separate dates, January 1, April 1, July 1, October 1, and December 31, 1983. Under section 318(a), no portion of the stock of the third corporation is constructively owned by the purchasing corporation until July 1, 1983, the date on which its ownership of the target corporation first exceeds 50 percent (sec. 318(a)(2)(C)). On that date, the purchasing corporation is treated as purchasing 30 percent (60 percent of 50 percent) of the third corporation. By virtue of the remaining purchases of the target corporation stock, the purchasing corporation will be treated as having purchased 50 percent of the third corporation's stock by December 31, 1983. If, by June 30, 1984 (the end of the 12-month acquisition period applicable to the third corporation), either the purchasing corporation or the target corporation purchases an additional 30 percent of the third corporation, an election, if made for the target corporation, would also apply to the third corporation.

In the above example, the amount for which the assets of the third corporation are treated as sold (and purchased) is determined by reference to the portion of the price paid for the target corporation's stock allocable to the 50-percent interest in the third corporation's stock owned by the target corporation plus any amount paid to purchase an additional 30 percent or more of such stock after December 31, 1983, and within the remaining portion of the acquisition period applicable to the third corporation.

A purchase of over 80 percent but less than 100 percent of the stock of a target corporation which in turn owns 80 percent of the stock of a third corporation is not a qualified stock purchase with respect to the third corporation because the purchasing corporation has not acquired by purchase the requisite 80 percent of the third corporation's stock. This is so, even though the purchasing corporation, the target corporation, and the third corporation constitute an affiliated group as defined in section 1504(a).

Consistency requirement

The rules require consistency where the purchasing corporation makes qualified stock purchases of two or more corporations that are members of the same affiliated group. For this purpose, purchases by a member of the purchasing corporation's affiliated group, except as regulations provide otherwise, are treated as purchases by the purchasing corporation. The consistency requirement applies as well to a combination of a direct asset acquisition and qualified stock purchase.

The consistency requirement applies with respect to purchases over a defined "consistency period" determined by reference to the acquisition date applicable to the target corporation. The "consistency period" is the one-year period preceding the target corporation acquisition period plus the portion of the acquisition period up to and including the acquisition date, and the one-year period following the acquisition date. Thus, if all the target corporation's stock is purchased on the same day by the purchasing corporation, the one-year period immediately preceding and the one-year period immediately following such day are included in the consistency period. If, within such period, there is a direct purchase of assets from the target corporation or a target affiliate by the purchasing corporation, the rules require that the acquisition of the target corporation be treated as an asset purchase.

The consistency period may be expanded in appropriate cases by the Secretary where there is in effect a plan to make several qualified stock purchases or any such purchase and asset acquisition with respect to a target corporation and its target affiliates.

The consistency requirement is applied to an affiliated group with reference to a target corporation and any "target affiliate." A corporation is defined as a "target affiliate" of the target corporation if each was, at any time during that portion of the consistency period ending on the acquisition date of the target corporation, a member of an affiliated group that had the same common parent. An affiliated group has the same meaning given to such term by section 1504(a) (without regard to the exceptions in sec. 1504(b)). This definition also applies in determining whether a purchase is made by a member of the same affiliated group as the purchasing corporation.

An acquisition of assets from a target affiliate during the consistency period applicable to the target corporation will require the qualified stock purchase of the target corporation to be treated as a purchase of assets.

Where there are, within a consistency period, only qualified stock purchases of the target corporation and one or more target affiliates by the purchasing corporation, an election with respect to the first purchase will apply to the later purchases. A failure to make the election for the first purchase will preclude any election for later purchases.

The application of the consistency requirements are illustrated in the following examples:

Example 1

The acquiring corporation makes a qualified stock purchase of T's stock and within a one-year period purchases assets from a target affiliate of T. The acquiring corporation is deemed to have made an election with repect to T as of the acquisition date applicable to T.

Example 2

The acquiring corporation makes a qualified stock purchase of T's stock and makes the election within 75 days of the acquisition date. The acquiring corporation is treated as having acquired by purchase the stock of any other corporation owned by T actually or constructively which is attributed to the acquiring corporation under section 318(a) (other than sec. 318(a)(4)). To the extent that such treatment results in qualified stock purchases by the acquiring corporation of other corporations actually or constuctively owned by T, the election with respect to T applies to all such corportions. Each such corporation will be treated as having sold (and as having purchased as a "new" corporation) its assets on the acquisition date with respect to T. Gain or loss will not be recognized to the extent gain or loss is not recognized under section 337. The deemed sale price of the assets will be determined by reference to the amount allocated to the stock of each selling corporation as a result of the qualified stock purchase and election with repect to T.

Example 3

P, an acquiring corporation, makes a qualified stock purchase of all the stock of corporation T on February 1, 1983. No election is made. On December 1, 1983, P makes a qualified stock purchase of all the stock of corporation U, a target affiliate of corporation T. No election may be made with respect to corporation U.

In applying these rules, acquisitions of assets pursuant to sales by the target corporation or a target affiliate in the ordinary course of its trade or business and acquisitions in which the basis of assets is carried over will not cause the consistency requirements to apply. The sale by a target corporation will be considered as a sale in the ordinary course of business for this purpose even though it is not customary in the course of the selling corporation's business provided it is a transaction that is a normal incident to the conduct of a trade or business, such as a sale of used machinery that was employed in the seller's trade or business.

To prevent avoidance of the consistency requirements, the bill authorizes the Secretary to treat stock acquisitions pursuant to a plan and satisfying the 80-percent requirement to be treated as qualified stock purchases even though they are not otherwise so defined. For example, an acquiring corporation may acquire 79 percent of the stock of a target corporation and, within a year, purchases assets from such corporation or a target affiliate planning to purchase the remaining target corporation stock more than one year after the original stock purchase. The Secretary may under these circumstances treat the purchase of the target corporation's stock as a deemed sale of its assets by the target corporation. The bill also authorizes such regulations as may be necessary to ensure that the requirements of consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates are not circumvented through the use of other provisions of the law or regulations, including the consolidated return regulations.

Effective Date

The treatment prescribed for qualified stock purchases applies to any target corporation with respect to which the acquisition date occurs after August 31, 1982.

d. Revenue effect

It is estimated that these provisions will increase budget receipts by $693 million in fiscal year 1983, $824 million in 1984, $745 million in 1985, $661 million in 1986, and $572 million in 1987.

10. Accounting Methods

a. Completed contract method of accounting (sec. 231 of the bill)

Present Law

Overview

A taxpayer who enters into long-term contracts may elect to use one of four accounting methods to account for the income and expenses attributable to such contracts. Long-term contracts generally are building, installation, construction, or manufacturing contracts that are not completed by the end of the taxable year in which they were entered into. A manufacturing contract is not a long-term contract unless it involves the manufacture of either (1) unique items of a type not normally carried in the finished goods inventory of the taxpayer or (2) items that normally require more than 12 months to complete.

The four methods used to account for long-term contracts are the cash method, the accrual method, the percentage of completion method, and the completed contract method. The cash and accrual methods are methods applicable to all types of income of all taxpayers generally. The percentage of completion method and the completed contract method apply only to long-term contracts.

Cash method

Under the cash method, income is reported for the year in which it is actually or constructively received. Deductions generally are taken for the year in which actually paid. Therefore, a taxpayer who uses the cash method to account for income and expenses for long-term contracts includes payments in income when received (either before or after completion of the contract) and takes deductions for expenses when actually paid.

Accrual method

Under the accrual method, income is generally reported when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when it is received. Where the taxpayer accrues income on shipment, delivery, or acceptance under the accrual method, advance payments under a long-term contract are includible at the time of shipment, delivery, or acceptance.

If an accrual basis taxpayer does not use inventories in connection with a long-term contract, deductions generally are allowed for the year in which all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. If the taxpayer uses inventories, costs allocable to inventory are accumulated until the inventory is shipped, delivered, or accepted.

Percentage of completion method

Under the percentage of completion method (which is used only for long-term contracts), income is recognized according to the percentage of the contract that is completed during each taxable year. The computation of how much of the contract is completed during a taxable year may be made by comparing (1) the costs incurred during the year to the total estimated costs of the contract or (2) the physical work performed on the contract during the year to the total estimated work to be performed. Expenses of the long-term contract are deductible for the year in which paid or incurred.

Completed contract method

Overview

Under the completed contract method (which is used only for long-term contracts), income and costs from the contract generally are reported for the year in which the contract is completed.

Completion of the contract

Present Treasury regulations (§ 1.451-3) provide that a contract will not be considered completed until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay completion of a contract for the principal purpose of deferring Federal income tax. For a subcontractor who completes his work on a long-term contract before completion of the entire contract, "final completion and acceptance" of the contract is deemed to occur for the subcontractor when the subcontractor's work has been completed and has been accepted by the party with whom he has contracted. In cases where there is a contract dispute after the taxpayer has tendered the subject matter of the long-term contract to the purchaser, special rules are provided to determine when income and costs are to be taken into account.

Severing and aggregating contracts

Present Treasury regulations also provide that it may be necessary to treat one agreement as several contracts or several agreements as one contract in order to clearly reflect the income of the taxpayer. Whether one agreement is severed or several agreements are aggregated depends on all the facts and circumstances. Generally, one agreement will not be treated as several contracts unless either (1) the agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract or (2) there is no business purpose for entering into one agreement rather than several. Generally, several agreements will not be treated as one contract unless either (1) the several agreements would be treated as a single agreement under customary commercial practice in the taxpayer's trade or business or (2) there is no business purpose for entering into several agreements rather than one. The fact that one agreement would not have been made on the agreed-upon terms if the same parties had not made a second agreement is evidence that the two agreements should be treated as a single contract.

Deduction of expenses

Under the completed contract method, expenses allocable to the contract (commonly referred to as "contract costs") are deductible for the year in which the contract is completed. Expenses that are not allocated to the contract (commonly referred to as "period costs") are deductible for the year in which they are paid or incurred.

Under existing regulations, contract costs include all direct expenses and indirect expenses that are incident and necessary to the performance of the contract, with the following exceptions (which are currently deductible as period costs):

(a) Marketing and selling expenses, including bidding expenses;

(b) Advertising expenses;

(c) Other distribution expenses;

(d) General and administrative expenses which benefit the taxpayer's business as a whole;

(e) Interest;

(f) Research and development expenses;

(g) Losses, under section 165 and the regulations thereunder;

(h) Percentage depletion in excess of cost depletion;

(i) Depreciation on idle equipment and, for other equipment, tax depreciation in excess of book depreciation;

(j) Income taxes:

(k) Pension and profit-sharing contributions and other employee benefits;

(l) Costs attributable to strikes, rework, scrap, and spoilage; and

(m) Officer compensation which benefits the taxpayer's activities as a whole.

Reasons for Change

The committee believes that the present rules relating to the completed contract method of accounting need to be changed because the income of some taxpayers using that method of accounting is not being clearly reflected. The method has not resulted in a clear reflection of income due, in part, to deferral of the completion of the contract for tax purposes by reason of contractual obligations that are merely incidental to the taxpayer's obligation to build, construct, install, or manufacture the subject matter of the contract. Also, completion of contracts has been deferred for tax purposes by treating certain agreements as a single contract for several units rather than several contracts for single units, even though each unit is delivered or accepted separately and has been separately and independently priced. The committee believes, therefore, that Treasury should amend its regulations to prevent this inappropriate deferral of income.

In addition, clear reflection of income under the method has not occurred in certain cases because many significant costs that are incident to and necessary for the performance of long-term contracts currently are treated as period costs and, therefore, are not matched with the income to which they relate. This problem is of less concern in the case of contracts that are completed in a relatively short period of time, e.g., two years or less. Therefore, the committee believes that Treasury should amend its regulations to require, generally, that, in the case of contracts expected to take more than 24 months to complete, costs that directly benefit, or are incurred by reason of, such extended period long-term contracts should be allocated to such contracts. However, in the case of construction contracts, which the committee understands usually have less than a 36 months duration, the committee is concerned that many small businesses would be unduly burdened by a requirement to allocate more indirect costs to long-term contracts. Therefore, the committee believes it is appropriate that construction contracts that are expected to be completed within 36 months should not be subject to the new cost allocation rules. Also, in the case of small businesses with average annual gross receipts of no more than $25 million, the committee believes it is appropriate to exempt all construction contracts of such businesses from the new cost allocation rules.

The committee recognizes that the new cost allocation rules will have a significant impact on certain taxpayers. Therefore, as a transition rule, the committee believes it is appropriate to phase in the new cost allocation rules over a 3-year period.

Explanation of Provision

The committee bill directs the Treasury to modify its regulations relating to the determination of when a contract is completed and when agreements should be severed or aggregated. Also, the Treasury is directed to modify its regulations relating to the use of the accrual method of accounting with respect to long-term contracts. The committee intends that these modified rules would prevent unreasonable deferral of recognition of income and will apply to all taxpayers who use either the completed contract method of accounting or the accrual method of accounting.

The committee bill also directs the Treasury to modify its regulations relating to the allocation of costs to long-term contracts.[1] Except as provided in the case of certain construction contracts, costs that are treated as period costs under present law will be allocated to long-term contracts if such costs either directly benefit, or are incurred by reason of, contracts that are not estimated to be completed within 24 months (extended period long-term contracts). These costs include the following:

(1) Bidding expenses on contracts awarded to the taxpayer;

(2) Distribution expenses, such as shipping costs;

(3) General and administrative expenses properly allocable to long-term contracts under regulations to be prescribed by the Secretary;

(4) Research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred or are incurred under an agreement to perform research and development;

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[1] In order to prevent avoidance of the new cost allocation rules, it is anticipated that Treasury may be required to amend both the regulations relating to the completed contract method and the regulations relating to the full absorption inventory costing method.

(5) Depreciation, capital cost recovery, and amortization for equipment and facilities currently being used, to the extent it exceeds depreciation reported by the taxpayer for financial accounting purposes;

(6) Pension and profit-sharing contributions representing current service costs and other employee benefits;

(7) Rework labor, and scrap and spoilage; and

(8) Percentage depletion in excess of cost depletion.

Costs that would continue to be currently deductible include the following:

(1) Interest;

(2) Marketing, selling, and advertising expenses;

(3) Bidding expenses for contracts not awarded to the taxpayer;

(4) Research and development expenses neither directly attributable to particular long-term contracts existing when the expenses were incurred nor incurred under an agreement to perform such research and development;

(5) Losses under section 165 and the regulations thereunder;

(6) Depreciation, capital cost recovery, and amortization for idle equipment and facilities;

(7) Income taxes attributable to income received from long-term contracts;

(8) Pension and profit-sharing contributions representing past service costs;

(9) Costs attributable to strikes; and

(10) General and administrative expenses not allocable to long-term contracts under regulations to be prescribed by the Secretary.

With respect to general and administrative expenses, the committee intends that the Treasury will issue regulations that require additional costs to be allocated to extended period long-term contracts, i.e., those costs that directly benefit or are incurred by reason of the performance of extended period long-term contracts. Costs may directly benefit extended period long-term contracts of the taxpayer even though the same type of costs also benefit other activities of the taxpayer.

These new contract cost allocation rules will not apply in the case of construction contracts entered into in a taxable year if the taxpayer's average annual gross receipts from all businesses over the 3 preceding taxable years is $25 million or less. For purposes of this rule, all trades or businesses under common control will be treated as one taxpayer. The determination of "common control" will be made in a manner consistent with the principles of section 52. In order to prevent abuse of the gross receipts test, the Treasury will prescribe any regulations necessary to deal with taxpayers who engage in construction contracts through partnerships, joint ventures, and corporations.

Also, the new contract cost allocation rules will not apply to any other taxpayer in the case of a construction contract that is expected to be completed within 36 months. For purposes of these special rules, a "construction" contract is a contract for the building or construction of an improvement to real property or the installation of integral components of an improvement to real property. An improvement to real property includes buildings, roads, dams, and similar property. Thus, for example, a contract for the installation of elevators in an office building is a construction contract. A contract to build elevators, on the other hand, is not a construction contract.[1]

For purposes of determining the expected length of time required to complete a contract, the beginning of the contract will be the time it is estimated that any costs allocable to the contract (other than bidding expenses) will first be incurred. The new contract cost allocation rules will be used to make this determination. The determination of the expected duration of the contract will be made when the contract is entered into.

Effective Date

The provisions of the committee bill relating to contract cost allocation rules will apply to costs incurred in taxable years beginning after December 31, 1982 with respect to contracts entered into after December 31, 1982. During a transition period, however, a percentage of the costs that would be treated as contract costs under the new allocation rules may, nevertheless, be deducted currently. The percentage of these costs that may be currently deducted is as follows:

For taxable year beginning in 1983, the currently deductible percentage is 66⅔;

For taxable year beginning in 1984, the currently deductible percentage is 33⅓; and

For taxable year beginning in 1985 and later years, the currently deductible percentage is 0.

No adjustment shall be made under section 481 by reason of a taxpayer's change in method of accounting for contract and period costs required by the committee bill. Such a change would include a change in method of accounting necessitated or permitted under the $25 million gross receipts test for construction contracts.

The other provisions of the committee bill, which relate to completion of a contract and contract aggregation and severance, apply to taxable years ending after December 31, 1982. In the case of a contract that the taxpayer has not treated as completed before the end of the taxpayer's first taxable year ending after December 31, 1982, such contract will be treated as completed in such taxable year if, under the regulations to be prescribed as directed by the committee bill, such contract would be considered completed in such taxable year or any earlier taxable year.

Revenue Effect

It is estimated that this provision will increase budget receipts by $822 million in fiscal year 1983, $2,235 million in 1984, $2,535 million in 1985, $2,390 million in 1986, and $2,559 million in 1987.

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[1] Where a contract covers both the manufacture and installation of an improvement to real property, an allocation between income and costs attainable to manufacture and installation must be made.

b. Annual accrual accounting method for corporate joint ventures of sugar producers (sec. 232 of the bill and sec. 447(g) of the Code)

Present Law

Under present law, the taxable income from farming of a corporation (or a partnership of which a corporation is a partner) generally must be computed using the accrual method of accounting with the capitalization of preproductive period expenses (sec. 447(a)). Preproductive period expenses are expenses (other than interest, taxes, or losses from casualty, drought, or disease) attributable to property having a crop or a yield that are incurred during the preproductive period of such property. The preproductive period for property is generally the period before the disposition of the property or the disposition of the first marketable crop or yield from the property.

This requirement, however, does not apply to subchapter S corporations, certain family corporations, or small corporations that meet a gross receipts test. Such corporations, and partnerships which have no other type of corporation as a partner, may use the cash method of accounting and may deduct preproductive period expenses when they are paid. The requirement to use the accrual method with the capitalization of preproductive period expenses also does not apply to the business of operating a nursery or a sod farm or the business of forestry or the growing of timber.

A special rule provides that certain corporations may use the "annual" accrual method of accounting (sec. 447(g)). Under the annual accrual method of accounting, preproductive period expenses are not capitalized, but are deducted currently. Corporations that qualify for this special rule are corporations that raise crops (such as sugar cane) which are harvested at least 12 months after planting. In addition, the corporation must have used the annual accrual method for the 10-year period ending with its first taxable year beginning after 1975, and must have continued to use such method for each taxable year after its first taxable year beginning after 1975.

In the case of a corporation that acquired substantially all the assets of a farming trade or business from another corporation in a transaction in which neither corporation recognized any gain or loss, the acquiring corporation is treated as having used the annual accrual method for the period such method was used by the predecessor corporation to compute the taxable income from the acquired farming business.

Reasons for Change

The committee believes that the present law relating to corporations which are permitted to use the annual accrual method unfairly discriminates against certain corporate joint ventures that grow sugarcane. Under present law, if a corporation is permitted to use the annual accrual method for a farming business, a corporation that acquires the business in a tax-free reorganization is also permitted to use the annual accrual method for the business. A partnership, however, that acquires such a business in a similar tax-free transaction is not permitted to use the annual accrual method if any of the partners is a corporation. The committee believes that a partnership, each of the partners of which is a corporation that engages in the business of growing sugarcane, other than a subchapter S corporation or personal holding company, should be treated the same as a corporation. Thus, if the annual accrual method is used by a corporation for the business of growing sugarcane and the business is contributed to such a partnership in exchange for an interest in the partnership, the partnership should be allowed to continue to use the annual accrual method for the business.

Explanation of Provision

Under the bill, a "qualified partnership" generally will be treated the same as a corporation for purposes of the annual accrual accounting rules of section 447(g). Under the bill, a qualified partnership is defined as a partnership in which each partner is a corporation that engages in the business of growing sugarcane, other than a subchapter S corporation or a personal holding company. A corporation engages in the business of growing sugarcane if substantially all of its activities involve the growing of sugarcane. The qualified partnership would have to meet the same general requirements that apply to corporations under present law. Thus, for example, the qualified partnership would have to be engaged in a farming business in which crops are raised that are harvested at least 12 months after planning.

The qualified partnership would also have to meet the requirement relating to continuous use of the annual accrual method. For this purpose, the bill provides a special rule analogous to the rule for transfers of a farming business from one corporation to another corporation. Under the special rule, if a partner of a qualified partnership has contributed a farming business to the partnership in exchange for a partnership interest, the qualified partnership would be treated as having used the annual accrual method for any period the contributing partner had used such method to compute its taxable income from the business.

Thus, for example, if a corporation that is permitted to use the annual accrual method with respect to a sugarcane growing business contributes substantially all of the assets of the business to a qualified partnership in exchange for an interest in the partnership, the qualified partnership would be permitted to use the annual accrual method to compute the taxable income from the business.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

Revenue Effect

The provision is estimated to result in an insignificant revenue loss.

11. Public utility dividend reinvestment plans (sec. 243 of the bill and sec. 305 of the Code)

Present Law

Public utility corporations may set up dividend reinvestment plans under which shareholders electing to receive distributions in the form of common stock, rather than money or other property, may exclude up to $750 per year ($1,500 in the case of a joint return) of the stock distribution from income. These amounts generally are taxed as capital gains when the stock is sold, if the stock has been held for at least 12 months.

The provision applies to distributions made after 1981 and before 1986.

Reasons for Change

The committee decided that an appropriate way to raise revenues would be to reassess tax incentive provisions that are too narrowly focused. The general objective of the reexamination was to retain the business tax incentives with the broadest, most neutral, stimulation to investment.

Tax-favored public utility dividend reinvestment diverts capital away from other industries which would make more productive investments if they had an even opportunity to raise funds in capital markets. Many firms, other than public utilities, have dividend reinvestment programs for shareholders, that do not rely upon special tax benefits. The committee believes that it is more preferable to direct business in need of capital to the capital markets, where there is a more neutral assessment of probable profits.

In addition to the foregoing general reasons to repeal the provisions, the committee took note of inequitable effects among individual taxpayers. This tax benefit provides for lower tax liability to an individual whose portfolio contains stocks with qualified public utility dividend reinvestment plans than to another individual with the same pretax income who holds different types of stocks. This provision also provided a windfall benefit to many taxpayers who already owned public utility stock before the tax benefit was enacted.

Explanation of Provision

The dividend reinvestment provision is repealed for distributions made after December 31, 1982. Stock distributed in 1982 will be unaffected.

Effective Date

The provision is effective for distributions made after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $149 million in fiscal year 1983, $416 million in 1984, and $449 million in 1985.

12. Amortization of original issue discount on bonds (sec. 236 of the bill and secs. 163 and 1232 and new sec. 1232A of the Code)

Present Law

Tax treatment of corporate original issue discount bonds

Normally, a bond is issued at a price approximately equal to the amount for which the bond will be redeemed at maturity, and the return to the holder of the bond is entirely in the form of periodic interest payments. However, in the case of original issue discount (OID) bonds, the issue price is below the redemption price, and the holder receives some or all of his return in the form of price appreciation. The spread between the issue price and redemption price is the original issue discount. The extreme case of an OID bond is a zero coupon bond, on which there are no periodic interest payments, and the holder's entire return comes from price appreciation.

Under present law, for bonds which are issued by a corporation and for which the period between the issue date and the stated maturity date is more than one year, the original issue discount is treated as accruing in equal monthly installments over the life of the bond. Thus, an issuer of an OID bond deducts, as interest, both any periodic interest payments and a ratable portion of the original issue discount each year, and the holder of the bond includes this same amount in income. For example, if a corporation issues a $1,000, 25-year bond paying a $70 annual coupon for an issue price of $500, it would deduct $90 for each full year over the life of the bond ($70 annual coupon plus 1/25th of the $500 original issue discount). The original holder of the bond would also report $90 of income for each full year he holds the bond. The basis of the bond in the hands of the holder is adjusted for the discount required to be included in income. Amounts included in income as original issue discount for each purchaser after the original holder are reduced by spreading any purchase premium (the excess of the purchase price over the issue price plus previous OID income inclusions) over the remaining life of the bond and deducting it on a ratable monthly basis from OID included in income.

For corporate bonds for which the period between the issue date and the stated maturity date is one year or less, the holder does not accure income ratably; instead, gain on sale or exchange, or redemption, is treated as interest income to the extent of what would have been the accrued OID.

Present statutory rules explicitly prescribe the treatment of OID only with respect to holders of corporate and taxable government obligations that are capital assets in the hands of the holder (sec. 1232). The rule for holders of short-term corporate bonds is in section 1.1232-3A(b)(2) of the income tax regulations. For corporate issuers, the analogous rules governing the deduction of OID are prescribed by section 1.163-4 of the income tax regulations. The treatment of issuers prescribed by the regulations applies to both cash and accrual basis issuers. This regulatory treatment of corporate issuers achieves substantial parity of treatment between issuers and the holders of corporate bonds, who are required by section 1232 to include OID in taxable income ratably over the life of the bond.

Tax treatment of noncorporate original issue discount bonds

The statutory rules applicable to holders of OID bonds (sec. 1232) do not require OID on noncorporate bonds to be included in income ratably over the life of the bond. For government bonds, such rules require ordinary income treatment of the portion of any gain from the sale or redemption consisting of accrued OID. A cash basis holder of noncorporate bonds defers the inclusion of OID in income until the bond is sold or redeemed.

Example comparing corporate OID and ordinary bonds

Assume a 15-percent interest rate. Suppose a business wants to borrow $1 and then borrow at the end of the year to pay all interest charges for the year, and repeat this sequence each year for 30 years. Its interest payments would be 15 cents in the first year, 17.3 cents the second year (15 percent interest on the outstanding balance of $1.15), and so on, and would grow exponentially, eventually equaling $8.64 in the 30th year. At the end of 30 years, the overall debt would mount up to $66.21. A total of $65.21 in interest would be paid, and deducted, over the period, but the deductions would start small and grow.

The taxpayer could achieve the same substantive result by issuing a zero-coupon bond at a price of $1 redeemable for $66.21 in 30 years. However, by using the OID bond, the taxpayer can obtain a deduction of $2.17 each year ($65.21 divided by 30). Thus, the OID bond allows larger interest deductions in early years than borrowing the same amount with ordinary loans. In this example, the taxpayer deducts in the first year more than twice the amount borrowed and more than 14 times the real interest. Conversely, the purchaser of the OID bond includes more interest in his income in early years than the purchaser of an ordinary bond.

Table 1 shows the different patterns of deductions for the issuer and income inclusion for the holder between a zero-coupon bond and borrowing with ordinary loans under present law.

TABLE 1.—COMPARISON OF INTEREST DEDUCTIONS AND INCOME INCLUSION BETWEEN BORROWING $1 WITH ZERO-COUPON BONDS AND WITH ORDINARY LOANS UNDER PRESENT LAW

[Dollars]

Year	Ordinary loans	Zero-coupon bond	Difference
1982	0.150	2.174	2.024
1983	.173	2.174	2.001
1984	.198	2.174	1.976
1985	.228	2.174	1.946
1986	.262	2.174	1.912
1987	.302	2.174	1.872
1988	.347	2.174	1.827
1989	.399	2.174	1.775
1990	.459	2.174	1.715
1991	.528	2.174	1.646
1992	.607	2.174	1.567
1993	.698	2.174	1.476
1994	.803	2.174	1.371
1995	.923	2.174	1.251
1996	1.061	2.174	1.113
1997	1.221	2.174	.953
1998	1.404	2.174	.770
1999	1.614	2.174	.560
2000	1.856	2.174	.318
2001	2.135	2.174	.039
2002	2.455	2.174	−.281
2003	2.823	2.174	−.649
2004	3.247	2.174	−1.073
2005	3.734	2.174	−1.560
2006	4.294	2.174	−2.120
2007	4.938	2.174	−2.764
2008	5.679	2.174	−3.505
2009	6.530	2.174	−4.356
2010	7.510	2.174	−5.336
2011	8.636	2.174	−6.462
Total	65.212	65.212	0
Present value (computed at 8.1 percent after-tax rate)	11.738	24.245	12.505

Assumptions

Ordinary bond: Taxpayer borrows $1 in 1981 and borrows every year to pay the interest on the outstanding indebtedness. Interest rates remain at 15 percent. All debt repaid in 2011.

Zero-coupon bond: Taxpayer issues bond for price of $1 with no coupon, maturing in 30 years at a price of $66.21 (15-percent yield to maturity).

Reasons for Change

The larger deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of interest-bearing bonds not issued at a discount is a substantial tax advantage to the former, an advantage that increases with the term of the bonds. The current ratable OID amortization formula was adopted at a time when interest rates were considerably lower than at present and when the formula involved a much smaller distortion. The current formula is significantly different from the formula which issuers use to compute interest deductions on financial statements and does not represent a proper measurement of interest costs to the issuer. There is no justification for providing what is, in effect, a tax incentive for issuing long-term OID bonds.

Moreover, the larger income inclusion for OID bond purchasers in early years, relative to purchasers of nondiscount bonds, unjustifiably penalizes those who wish to take advantage of the opportunity the OID bond provides to guarantee the reinvestment of the interest payments at the bond's initial yield to maturity. Under present law, only tax-exempt borrowers, such as pension funds, can avoid this penalty.

The committee also believes that the treatment of holders of OID bonds should be comparable, whether the bonds are corporate or noncorporate obligations, and that the treatment of taxable, noncorporate issuers of OID bonds should be comparable to the treatment of corporate issuers.

Explanation of Provision

The committee bill provides new rules for computing the method of amortizing original issue discount, using a method that parallels the manner in which interest would accrue through borrowing with interest-paying, nondiscount bonds.

Under the formula prescribed in the bill, the OID is allocated over the life of the bond through a series of adjustments to the issue price for each "bond period." The adjustment to the issue price for any bond period is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity and then by subtracting the interest payable during the bond period.[1] The adjustment to the issue price for any bond period is the amount of the OID allocated to that bond period.

Except as regulations may provide otherwise, a bond period for any given bond is each one-year period beginning on the date of issue of the bond and each anniversary thereof, or the shorter period to maturity for the last bond period. The increase in the adjusted issue price for any bond period is allocated ratably to each day in the bond period.

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[1] Assume that a bond is issued at a price P_0, pays an annual coupon i, and is redeemable in N years for a price of one dollar. The yield to maturity (r) is the solution to the following equation:
$P_0 = i/r[1 - 1/(1+r)^N] + 1/(1+r)^N$
The adjustment to the issue price in the first bond year is given by $P_1 - P_0 = rP_0 - i$.
In general, if the adjusted issue price at the beginning of bond period t is P_{t-1}, the increase in the adjusted issue price during that bond period will be $P_t - P_{t-1} = rP_{t-1} - i$.
The bond holder will include in income, and the bond issuer will deduct, the increase in the adjusted issue price plus the cash interest. For bond period t, this will be rP_{t-1}.

Each bond-holder must include in income the sum of the daily portions of OID so determined for each day during the taxable year the bond is held. When the taxable year of a holder overlaps more than one bond period (which will generally be the case unless the bond period happens to coincide with the holder's taxable year), the holder must include the appropriate daily portions for each of the relevant bond periods. The daily portions of OID includible in income or deductible will be reflected in the current earnings and profits of corporate bondholders and issuers.

As under present law, an offset to the amount included in income is allowed for subsequent holders purchasing at a price exceeding the issue price plus the daily portions of OID for all days prior to the purchase. For this purpose, such excess purchase price is allocated over the total number of days commencing with the purchase date through the day before the date of maturity. The transferee, not the transferor, is required to take into income the daily portion for the date of transfer.

Regulations are authorized to prescribe rules for the proper income inclusion where, because of varying interest rates, put or call options, or other circumstances, the statutory formula does not provide an inclusion that accurately reflects the income of the holder. This will include, among other cases, an early redemption where, at the time of original issue, there was an intention to call before maturity (the case covered by sec. 1232(a)(2) (A) and (B) of present law).

The new rule governing corporate OID bonds will be extended to obligations issued by noncorporate issuers other than natural persons. The OID income inclusion rules will thus apply to taxable discount government obligations and, for example, to discount obligations issued by a partnership after June 9, 1982. As under present rules for corporate bonds, the new OID income inclusion rules will apply only to bonds with a maturity date more than one year after the issue date. For bonds with a maturity of one year or less, gain on sale or redemption will be treated as interest income to the extent of what would have been accrued OID. However, tax-exempt bonds, United States Savings Bonds, and Treasury bills will be excluded from the new rules.

The existing rule requiring ratable monthly inclusion of OID on corporate bonds will be continued for bonds issued before May 4, 1982.

The new rules and the rules continuing existing law for pre-May 4 corporate bonds will both be included in a new Code section 1232A. As under present law, the basis of a bond will be increased for OID included in income, and the existing exceptions will be continued for bonds purchased at a premium and bonds held by a life insurance company to which section 818(a) applies. As in the case of corporate OID bonds under present law, the new income inclusion rules for OID will apply only to bonds that constitute capital assets in the hands of the holder. The definitional rules of section 1232(b) will continue to apply to the determination of original issue discount.

The aggregate daily portions of OID determined under the new rules that accrue during the taxable year of the issuer are the amount that the issuer may deduct. For this purpose, the deduction is limited to the sum of the daily portions of OID accruing during the issuer's taxable year without regard to any offset available to transferee holders. The rules governing the deduction for OID will be added to the Code (new sec. 163(e)). The deduction for OID will apply to all issuers of OID obligations (other than natural persons) regardless of whether the issuer uses the cash or the accrual method of accounting.

The bill would retain the rules of existing law that require gain from the sale or redemption of corporate bonds issued on or before May 27, 1969, and government bonds not subject to the new OID rules (those issued or treated as issued, under the binding commitment rule, before June 10, 1982) to be treated as ordinary income to the extent of OID. Otherwise, present law continues to define corporate and government bonds as capital assets, gain or loss from the sale or redemption of which constitutes capital gain or loss.

Effective Date

The new rules applicable both to income inclusion and deduction for OID with respect to corporate obligations apply to bonds issued after May 3, 1982, other than bonds issued under a written binding commitment entered into before May 4, 1982. The extension of the rules for income inclusion and deduction of OID to obligations issued by parties other than corporations applies to bonds issued after June 9, 1982, other than those issued under a written binding commitment entered into before June 10, 1982.

Revenue Effect

The revenue gain is expected to be $115 million in fiscal year 1983, $231 million in 1984, $367 million in 1985, $509 million in 1986, and $661 million in 1987.

13. Stripping of interest coupons from bonds (Sec. 237 of the bill and new sec. 1232B of the Code)

Present Law

The holder of a bond or other debt instrument who sells the bond with coupons attached between interest dates receives interest income to the extent of interest accrued to the date of sale, and the remainder of the sales proceeds is in exchange for the bond. This treatment is prescribed by section 1.61-7 of the income tax regulations. The bond holder may instead strip the unmatured interest coupons from the bond and dispose of either the coupons or the corpus of the bond (i.e., the right to receive the principal amount of the bond at maturity), or both the coupons and the corpus in separate transactions.

It is arguable that all of the taxpayer's basis in the debt instrument is allocated to the corpus, in which case a taxpayer who sells the corpus and retains the coupons may claim a loss on the sale of the stripped corpus equal to the difference between the amount for which he bought the debt instrument (with coupons attached) and the amount received for the corpus (without coupons). The loss, if allowable, would generally be an ordinary loss if the taxpayer is a dealer in such obligations or a bank. Otherwise, any loss allowable would be a capital loss.

For the person who buys the stripped corpus, gain on any later sale, or on redemption of the stripped corpus, is ordinary income to the extent of the difference between what would have been the value of the obligation with coupons attached at the time of its purchase and the actual cost of acquisition. For the purchaser of detached coupons, the coupons are a capital asset. The portion of the purchase price equal to the interest accrued to the date of purchase and taxed to the seller is, upon payment, a recovery of capital reducing the buyer's cost basis. Gain on the sale of the coupons may be treated as a capital gain. However, if the coupons are redeemed, the purchaser of the coupons has ordinary income equal to the difference between the amount received on redemption of each coupon and the purchase price allocable to that coupon.

Most coupon-stripping transactions involve U.S. government or agency obligations, but they may also involve tax-exempt obligations or taxable bonds issued by the private sector. For example, assume that a broker-dealer sells a $100,000 U.S. Government 20-year coupon bond with coupons detached for $8,000 immediately after the bond is issued. The $92,000 may constitute an ordinary loss to the seller. Also, the buyer of the stripped corpus who holds it until maturity will report no income until maturity, when he or she will report $92,000 of ordinary income. Thus, there is a tax deferral on $92,000 of income.

There is also a tax benefit to a purchaser of detached, unmatured interest coupons. In substance, each coupon is like an original issue discount bond, which should be subject to periodic inclusion rules. Under present law, income is deferred until the coupon is sold or redeemed.

Reasons for Change

Coupon stripping may permit income tax deferral through an artificial loss from selling the stripped bond, analogous to the deferral formerly accomplished through straddles that was eliminated by the Economic Recovery Tax Act of 1981 (Code secs. 263(g), 1092, and 1256). Deferral through coupon stripping should be subject to the same policy that eliminated deferral through straddles. Further, allocating the entire cost of an obligation with interest coupons to the corpus when a stripped bond or interest coupons are disposed of is economically unrealistic.

Upon disposition of the stripped corpus or the detached, unmatured coupons, both the retained portion and the portion disposed of represent the right to a fixed amount payable at a future date that is purchased at a discount. The committee believes that the periodic original issue discount (OID) inclusion rules applicable to obligations issued at a discount provide the appropriate tax treatment.

Explanation of Provision

The committee bill provides new rules under which, when a disposition separates ownership of a bond from the coupons detached from it, the stripped corpus and detached coupons are treated as OID bonds issued by a corporation on the date of disposition and are subject to the periodic income inclusion rules applicable to those bonds.

For the purchaser of a stripped bond, the excess of the stated redemption price at maturity over the portion of the purchase price allocable to the bond is the OID allocable to the purchased bond. It must be included in income periodically (under the new rules provided in section 236 of this bill) between the date of purchase and the date the bond matures. For the purchaser of a stripped coupon, the OID is the excess of the amount payable on the due date of the coupon over the portion of the purchase price allocable to the coupon. It must be included in income periodically (under the new OID inclusion rules) between the date of purchase and the due date of the coupon. The ratable share of the purchase price allocable to the corpus or a coupon is determined on the basis of their respective fair market values on the date of purchase.

The seller of a stripped bond or stripped coupons must allocate the basis, immediately before the disposition, of the bond with coupons attached between the items retained and the items disposed of. Subsequent to the disposition, the seller will be required to treat the retained items as OID bonds each having a purchase price equal to the amount of basis allocated to that item. Similar rules will apply to a person whose basis in a bond or coupon is determined by reference to the basis in the hands of a purchaser or seller of a stripped bond or stripped coupons.

The bill provides a special rule to deal with interest that has accrued on the bond at the time the taxpayer strips a bond or a coupon. Under this rule, interest accrued on the bond while the taxpayer holds the bond must be included in taxable income at the time the stripping occurs (just as would be the case had the entire bond been sold), and the taxpayer increases his basis in the bond by the amount of that accrued interest. This adjusted basis is then allocated between the corpus and the coupons in relation to their respective fair market values.

Under the new rules, no artificial loss can be created by selling a stripped bond with a basis reflecting value attributable to detached coupons. On the other hand, proceeds from the sale of stripped coupons will not constitute income to the seller to the extent that the seller's basis in the bond with coupons attached is allocated to the detached coupons. Instead, the retained items (either the detached coupons or the stripped corpus), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the seller's basis allocable to such retained items, will be treated as OID bonds requiring the seller to include OID in income under the new OID periodic income inclusion rules.

For the purchaser of a stripped bond, the excess of the redemption price over the purchase price must be taken into income under the new OID income inclusion rules but will not be subject to the requirement of present law converting gain on sale or redemption into ordinary income to the extent the purchase price was reduced because coupons were detached. The buyer of detached coupons must also take the excess of the price payable on the due date of the coupon over the purchase price into income under the new OID income inclusion rules and thus will be unable to defer and convert earned discount income into capital gain by selling coupons before they mature.

For taxable stripped bonds purchased before the effective date of the new rules, the bill continues the rule of present law requiring ordinary income treatment for gain on a sale or redemption of a bond corpus attributable to the difference in value of the bond with and without coupons attached at the time of purchase. For obligations the interest on which is not includible in income under section 103 (tax-exempt obligations), this rule of present law is preserved for bonds purchased after the effective date. The new OID income inclusion rules will not apply in the case of tax-exempt stripped bonds. However, the rule requiring a seller of a stripped bond or detached coupons to allocate the basis of the bond with coupons attached between the items retained and those disposed of will apply to a tax-exempt bond. Thus, as in the case of taxable obligations, the seller of a stripped tax-exempt obligation will be unable to create an artificial loss because basis is allocated to retained coupons under the rules. Also, if tax-exempt coupons are separately sold, there may be taxable gain on sale or redemption of the retained stripped bond attributable to allocation of a portion of the seller's basis to the detached coupons.

The new rules providing the tax treatment for stripped bonds are included in a new Code sec. 1232B. For purposes of applying these rules, a bond includes a debenture, note, or other evidence of indebtedness, a "stripped bond" is defined as a bond issued with interest coupons where there is a separation in ownership between the bond and any unmatured coupon, a "stripped coupon" is defined as any coupon relating to a stripped bond, the "stated redemption price at maturity" has the same meaning as in existing law (sec. 1232(b)(1)), and the term coupon includes any right to receive interest on a bond (whether or not evidenced by a coupon).

The bill repeals existing section 1232 (c) and (d) relating, respectively, to the requirement of ordinary income treatment of bonds with unmatured coupons detached and a cross-reference for special treatment of face-amount certificates.

Effective Date

The rules apply generally where there is a sale after June 9, 1982, of either a stripped bond or stripped coupons.

Revenue Effect

The revenue gain is expected to be $56 million in fiscal year 1983, $88 million in 1984, $106 million in 1985, $127 million in 1986, and $153 in 1987.

14. Extension and revision of targeted jobs credit (sec. 241 of the bill and sec. 51 of the Code)

Present Law

The targeted jobs credit is available, on an elective basis, for hiring individuals from one or more of nine target groups. The credit is equal to 50 percent of the first $6,000 of wages paid for the first year of employment and 25 percent of the first $6,000 of wages paid for the second year of employment to a target group individual.

For purposes of the credit, an individual is a member of a targeted group if the individual is: (1) a vocational rehabilitation referral, (2) an economically disadvantaged youth aged 18 through 24, (3) an economically disadvantaged Vietnam-era veteran, (4) an SSI recipient, (5) a recipient of money payments under a State or local general assistance program, (6) an economically disadvantaged youth aged 16 through 19 participating in a cooperative education program, (7) an economically disadvantaged ex-convict, (8) an eligible work incentive employee, and (9) an involuntarily terminated CETA employee.

The targeted jobs credit currently is available for wages paid to eligible individuals who begin work for the employer before January 1, 1983.

An authorization of $30 million of appropriations is provided for fiscal year 1982 for the expenses of administering the certification system and of providing publicity to employers. $5 million of the amount appropriated is used to verify the certification of target-group members using methods such as the depth verification of eligibility for a sample of certified individuals.

Reasons for Change

The committee believes that experience with the targeted jobs tax credit has been sufficiently promising to warrant its extension. Furthermore, the committee has agreed to several changes designed to make the provision more effective.

First, the committee believes that the credit should be extended for 3 more years.

Second, the committee has decided that the targeted jobs tax credit should be modified in a manner to encourage summer youth employment of economically disadvantaged teenagers. This is accomplished by expanding eligibility and increasing the amount of the credit for the hiring of economically disadvantaged youths who are 16 or 17 years of age for any 90-day period between May 1 and September 15.

Third, the committee believes that the credit for hiring cooperative education students should be available whether or not those individuals are members of economically disadvantaged families. Since this will greatly increase the number of qualified cooperative education students, the committee also has decided to reduce the amount of the credit for the hiring of those individuals.

Finally, the committee has decided that an amendment is needed with respect to the availability of the credit for general assistance recipients. The amendment is that recipients of non-cash, as well as cash, assistance will be eligible for certification.

Explanation of Provision

The bill extends the time period for which the targeted jobs tax credit will be available, adds an incentive for the hiring of summer youth employment, modifies the definition of cooperative education students and changes the amount of the credit with respect to the hiring of those individuals, and clarifies the definition of qualified general assistance programs.

Extension of credit

The bill extends the targeted jobs tax credit for three more years. Under the bill, the credit is available for wages paid to individuals who begin work for the employer on or before December 31, 1985. Thus, if an eligible individual begins work on December 31, 1985, the employer may claim credit for qualified first-year and qualified second-year wages paid to that employee attributable to service performed in 1986 and 1987 respectively.

The bill also extends the present authorization of appropriations for administrative expenses, so that $30 million is authorized for each of fiscal years 1983, 1984 and 1985. As under present law, $5 million of the amounts appropriated for each fiscal year is to be used to test whether the certification system used by State employment security agencies adequately screens out individuals who are not eligible for certification. In view of the committee's continuing concern about the extent to which the State agencies are certifying as eligible individuals who are not members of a target group, the committee intends that the Secretary of Labor report to Congress on his study of verification at regular intervals, at least annually.

Summer youth employment

In order to encourage summer youth employment, the bill allows employers to claim a tax credit for wages paid for the hiring of economically disadvantaged youths, who are 16 or 17 years of age on the hiring date, and who have not previously worked for the employer, for services attributable to any 90-day period between May 1 and September 15. With respect to any particular employer, an employee could qualify only one time for this summer youth credit.

The maximum amount of wages eligible for the credit for this target group will be $3,000. The credit is 85 percent of eligible wages, for a maximum credit of $2,550.

If, after the end of the 90-day period, the employer continues to employ a youth who is certified during the 90-day period as a member of another target group, the limit on qualified first-year wages will take account of wages paid to the individual while he or she was a qualified summer employee. For example, suppose a qualified summer youth employee begins work for an employer on May 15 and is paid $3,000 for wages attributable to services performed during the next 90 days. During this period, the employee obtains a second certification as a member of another targeted group for which the credit rate is 50 percent for qualified first-year wages. Since qualified first-year wages generally are limited to $6,000 for services attributable to the 12-month period beginning with the day the individual first begins work for the employer (May 15), wages eligible for the 50-percent credit are limited to $3,000 (the $6,000 limit minus the $3,000 paid to the individual while he was a qualified summer youth employee). A credit for qualified second-year wages could then be claimed for wages attributable to the 12-month period beginning the following May 15. The second certification will not be invalid merely because it was requested or received after the individual begins work for the employer; only the first certification (as a qualified summer youth employee) must meet the requirement of section 51(d)(15) that a certification must be requested or received by an employer before the day on which the individual begin work for the employer.

Cooperative education students

The bill eliminates the requirement that cooperative education students be members of economically disadvantaged families in order to be eligible for the credit. The bill also reduces the amount of credit that may be claimed for hiring cooperative education students.

Under the bill, the credit for the hiring of cooperative education students, whether or not members of economically disadvantaged families, will be limited to 30 percent of the first $3,000 of wages paid for the first year of employment (maximum $900 credit) and 15 percent of the first $3,000 of wages paid for the second year of employment (maximum $450 credit).

Definition of general assistance program for purposes of credit for hiring general assistance recipients

The bill provides that a qualified general assistance program includes a program that provides general assistance or similar assistance that is based on need and consists of certain non-cash (i.e., voucher or scrip), as well as cash, payments. As under present law, qualified general assistance programs will include only those based on need, and a recipient will be a member of a targeted group only after receiving assistance for at least 30 days.

Effective Dates

The extension of the targeted jobs tax credit will apply to eligible individuals who first begin work for the employer after December 31, 1982.

The credit for summer youth employment and the change applicable to general assistance recipients will apply to eligible individuals who first begin work for the employer after July 1, 1982.

The modification to the credit for hiring cooperative education students will apply to eligible individuals who first begin work for the employer after August 31, 1982.

Revenue Effect

This provision will reduce fiscal year receipts by $245 million in 1983, $637 million in 1984, $949 million in 1985, $830 million in 1986, and $181 million in 1987.

15. Accelerated corporate tax payments (sec. 242 of the bill and sec. 6655 of the Code)

Present Law

Rules applicable to corporations generally

Estimated tax

Under present law, a corporation generally must make payments of its estimated tax liability for the taxable year. The estimated tax is payable in up to four installments over the taxable year.

In general, if estimated tax payments are not equal to at least 80 percent of the tax due, a nondeductible penalty equal to the interest that will accrue on the unpaid tax imposed on the amount by which the payment is less than 80 percent of the tax due. However, the underpayment penalty does not apply if, before the due date of any installment, the corporation pays an installment based on:

(1) the corporation's tax liability for the prior year,

(2) the corporation's tax liability on the prior year's income computed using tax rates for the current year, or

(3) 80 percent of the tax which would be due if the corporation's annual income were equal to the amount which would result if the corporation continued to receive income during the remainder of the year at the same rate experienced up to the date of the installment (i.e., the corporation's income computed on an annualized basis).

Final payment of tax

As a general rule, a corporation's final tax payment is due with its income tax return 2½ months after the end of the corporation's taxable year. However, the corporation may elect to pay only half of the unpaid tax on this date and the second half three months later.

Refunds of overpaid tax generally are not made until after an income tax return is filed. However, quick refunds may be requested immediately after the close of the taxable year if the overpayment exceeds $500 and 10 percent of expected tax liability. Tax returns are due 2½ months after the end of the taxable year, but the Internal Revenue Service may grant a six-month extension of this date.

Special rules applicable to large corporations

In general, large corporations (i.e., those with taxable income of $1 million or more during any of the three preceding taxable years) are subject to the same rules on payment of income tax as are smaller corporations. Under present law, however, for 1984 and thereafter, a large corporation will not be able to use the first two exceptions above in order to avoid the underpayment penalties. For

1982 and 1983, large corporations will be able to use the first two exceptions only if their estimated tax payments equal at least 65 percent (in 1982) or 75 percent (in 1983) of the current year's tax liability.

Reasons for Change

The committee believes that there is no reason to permit corporations to defer a significant portion of their income tax liability until after the end of the taxable year. Allowing corporations this tax deferral amounts, in effect, to an interest-free loan from the Federal government. Therefore, the committee decided to increase, from 80 percent to 90 percent of actual tax, the amount of estimated tax payments required to avoid the underpayment penalty. The committee also decided to require that all remaining tax owed be fully paid on the return due date. In addition, the committee modified certain estimated tax requirements for large corporations.

However, the committee recognizes that in computing the tax liability of a corporation, there are numerous issues of law and fact that can affect tax liability. Because the increased estimated tax payments will demand greater precision in estimating this tax liability, the committee decided to permit a lower penalty for the portion of the underpayment of estimated taxes between 80 percent and 90 percent of actual tax due.

Explanation of Provision

The bill provides that, for all corporations, for 1983 and thereafter, the amount of estimated tax payments required to avoid underpayment penalties will be increased from 80 percent to 90 percent of current year's tax liability. A corresponding change will be made in the third exception (estimated payments based on annualized income), above. Furthermore, the full amount of unpaid tax will be due 2½ months after the end of the taxable year.

The bill also provides that, for 1984 and 1985, the first two exceptions to the underpayment penalty (estimated payments based on prior year's tax liability or income) will be available to large corporations only if estimated tax payments are at least 80 and 85 percent respectively, of tax due. These exceptions will not be available to large corporations after 1985. Thus, after 1985, to avoid underpayment penalties, large corporations will be required to pay at least 90 percent of their current tax liability through estimated payments unless the third exception is applicable.

In addition, the penalty on underpayments of estimated tax that are between 80 percent and 90 percent of the actual tax due will be imposed at one-half the full rate for underpayments.

Effective Date

The provisions of the bill will apply to taxable years beginning after December 31, 1982.

Revenue Effect

This provision will increase fiscal year budget receipts by $798 million in 1983, $1,110 million in 1984, $1,518 million in 1985, $1,861 million in 1986, and $442 million in 1987.

C. Provisions Designed to Improve Taxpayer Compliance

1. Withholding on interest and dividends (secs. 301-310 of the bill and secs. 3451-3454 of the Code)

Present Law

Overview

Present law requires information reporting for payments of most types of interest, dividends and patronage dividends but does not require withholding on such payments, except in the case of payments to certain foreign persons. Among the types of payments for which there are no information reporting requirements are payments of interest on bearer obligations and exempt governmental obligations.

Withholding requirements for wages

Under present law, an employer who pays wages to individual employees (or has employees who report tips) must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income tax liability. The term "wages" generally is defined as all remuneration, unless specifically excluded, paid for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash.

The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary. Except in the case of certain foreign persons and payments subject to withholding under the windfall profit tax, there is generally no requirement under present law for withholding on payments other than wages.

Wage withholding exemptions

Individuals whose wages are subject to withholding may be entitled to exempt their wages from withholding in $1,000 increments (exemptions). The exemptions allowed include (1) one exemption for the taxpayer; (2) one additional exemption if the taxpayer has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) an exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming the exemptions on a separate return; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket amount allowance, unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding exemptions for excess itemized deductions, tax credits and other items specified in Treasury Regulations.

An individual subject to withholding may reduce or increase the number of exemptions claimed (under procedures set forth in the regulations) so that withheld taxes will more closely equal his or her anticipated tax liability. Employees who incurred no income tax liability for the preceding taxable year and expect to have no income tax liability for the current taxable year may claim total exemption from wage withholding.

Wage withholding exemption certificates

An individual may claim withholding exemptions by furnishing his or her employer with a withholding exemption certificate (Form W-4). In the case of new employment, this certificate must be furnished on or before the date employment begins. If no exemption certificate is furnished, the employee is considered as unmarried and claiming no exemptions.

When a change occurs which decreases the number of withholding exemptions which an employee is entitled to claim, the employee must furnish the employer with a new exemption certificate reflecting the correct number of exemptions. Such new certificate must be furnished within ten days after the change occurs. In addition, a new certificate is required when an employee who has claimed complete exemption from withholding can no longer reasonably anticipate no income tax liability for the current taxable year.

An employer is required to submit to the Internal Revenue Service a copy of a withholding exemption certificate received from an employee during the reporting period if (1) on the last day of the reporting period, the employee is employed by that employer and claims more than fourteen withholding exemptions, or (2) the employee claims complete exemption from withholding unless the employer reasonably expects that the employee's wages from the employer will not usually exceed $200 a week.

Voluntary withholding on pensions

Under present law, annuity or pension payments are subject to withholding to the extent includible in gross income if the payee so requests. Such request must be made in writing to the payor of the annuity or pension.

The amount requested to be withheld from a pension or annuity must be at least $5 per month and must not reduce the net amount of any pension or annuity payment below $10.

Withholding on gambling winnings

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent. In general, gambling winnings are subject to withholding if the proceeds exceed $1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from State-conducted lotteries and winnings from sweepstakes, wagering pools, certain parimutuel pools, jai alai, and other lotteries.

The payor of gambling winnings that are subject to withholding is required to file Form W-2G with the Internal Revenue Service Center serving the district in which the principal place of business of the person filing the return is located.

Withholding on foreign investors

In general, the United States taxes U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with the conduct of a trade or business in the United States at a flat rate of 30 percent (or a lower treaty rate) of the gross amount paid. This tax is collected through withholding by the person making the payment to the foreign recipient. Income effectively connected with a U.S. trade or business is not subject to the flat 30-percent withholding tax, but instead is includible in the U.S. income tax return of the business and is taxed at the regular graduated rates (and is not subject to withholding at source).

Certain noneffectively connected U.S. source income such as interest from bank deposits, and original issue discount on obligations maturing in six months or less, is exempt from U.S. tax, and therefore withholding. Also, the income of foreign governments from investments in the United States in bonds, stocks, and other securities, or from interest on bank deposits, is exempt from U.S. tax.

Reasons for Change

The Internal Revenue Service estimates that 15 percent of dividend income and 11 percent of interest income is not reported by taxpayers. In contrast, 99 percent of wage income is reported by taxpayers. The committee believes that the difference in compliance rates is best explained by the fact that wages are subject to withholding but interest, dividends and patronage dividends are not. Withholding improves voluntary compliance for several reasons. First, once tax has been withheld from an amount of income, any incentive a taxpayer had to conceal or overlook the income in preparing his return is reduced or converted to an incentive to report the income and claim the withholding credit. Second, since the taxpayer's ability to claim a credit for withheld amounts depends upon the payor accurately reporting with respect to withheld amounts, information reports submitted with respect to payments subject to withholding are significantly more accurate. Thus, the Internal Revenue Service can more easily detect noncompliance and take effective enforcement actions promptly and with a minimum of intrusion into the affairs of taxpayers and third parties. Finally, imposition of withholding serves as an effective reminder to taxpayers that the payments subject to withholding should be reported as income.

In considering whether withholding should be required on dividends, patronage dividends and interest payments, the committee examined not only the potential for improved compliance but also the burdens on taxpayers and payors of dividends, patronage dividends and interest. The committee believes that the exemption provisions of the bill permitting certain persons to claim exemption from withholding, combined with the flexibility permitted in the wage withholding and estimated tax systems will prevent involuntary over-withholding or overpayment of estimated taxes. Further, the committee believes that a properly designed and administered withholding system will be substantially less intrusive than the kind of examination and collection effort that would have to be undertaken to achieve a comparable level of compliance in the absence of withholding. Finally, the committee believes that the evolution of electronic data processing in recent years will enable the private sector to process the information necessary to operate a withholding system efficiently and effectively.

Explanation of Provision

Overview

Generally, the bill provides for a limited system of withholding on payments of dividends, patronage dividends, or interest to individuals (other than certain low income and elderly individuals) at a rate of 10 percent. Withholding is also required on payments to unincorporated entities, such as partnerships or estates, which are not themselves required to withhold on payments to individuals. Interest subject to withholding requirement includes most interest paid by persons other than individuals, including payments by the United States and payments on bearer obligations. Dividends subject to the withholding obligation include most of the distributions of property by a corporation to its shareholders out of its earnings and profits that are subject to information reporting under present law. Withholding is also required on most payments of patronage dividends by cooperatives. Exemptions are specifically provided for (1) payments to individuals who had no tax liability in the preceding year, (2) payments to elderly persons whose tax liability was $1,500 or less ($2,500 on a joint return) in the preceding year, (3) payments on the redemption of United States savings bonds the interest on which aggregates $10 or less in any transaction, (4) payments by consumer cooperatives, (5) payments to corporations, government, security dealers, money market funds, exempt organizations, and nominees or custodians, and (6) if the payor elects to not withhold, payments which on an annual basis would aggregate $10 or less during the calendar year.

The bill provides that, in implementing the withholding requirements, the Treasury is to take into account the costs incurred by payors in instituting withholding and the special problems faced by small banks. Specifically, the Treasury is to structure rules for paying withheld taxes over to the Treasury taking into account start-up costs of withholding agents. Further, small banks will be exempted from the withholding requirement (except to the extent they elect, under regulations, to have all such provisions apply) until they are able to comply.

Obligation to withhold

Under the bill, every withholding agent who makes a payment of interest, dividends, or patronage dividends must withhold an amount equal to 10 percent of the payment. Generally, a withholding agent will be the person primarily liable to make the payment of interest or dividends (*e.g.*, the issuer of an evidence of indebtedness or the corporation declaring the dividend). In some cases, the financial institution, broker or nominee who acts as a middleman between an individual and the primary obligor will be the withholding agent. Thus, for example, if a corporation issues a debt obligation which is held by an individual, the corporation will be required to withhold on the payment of interest to the individual. However, if the obligation is held by a brokerage firm for the benefit of an individual, the corporation will not withhold on its payment to the brokerage firm, but the firm will withhold from its payment to the individual. Similarly, the bill provides that if a corporate trustee receives any payment of interest, dividends or patronage dividend, which is not subject to withholding, then the corporate trustee must withhold the 10-percent tax as if it had made the payment to the trust.

Because the definition of interest excludes interest on obligations of natural persons, individuals will not be withholding agents unless they act as nominees or custodians for another individual.

Generally, the tax must be withheld when the interest, dividends, or patronage dividends are paid or credited to the payee unless otherwise provided in the Code or regulations. Thus, for example, if a payor pays interest every six months, withholding will be required twice a year. If, however, a payor credits interest to a customer every month, so that the customer is able to use that interest, then the payor will be required to withhold monthly. The bill does not require payors of interest or dividends to alter the system under which they presently credit payments to payees. Rather, the bill simply requires that whenever a payor does make a payment available to its payees, it must deduct and withhold the 10-percent withholding tax.

Banks and savings institutions would be permitted to elect, in the manner provided by regulations, to defer withholding on payments of interest on deposits in certain savings and checking accounts and similar accounts, such as credit union share accounts, until a date not later than the last day of the year in which the payment is made.

It is anticipated that the regulations providing for this election will require the payor to agree that the balance in any account for which the election is made will not be permitted to fall below the amount of tax that would have been deducted and withheld up to the day of withdrawal in the absence of the election. The payor will also be required to accelerate the deduction and withholding of tax with respect to accounts for which the election is made when the account is closed prior to the date elected for deducting and withholding tax. This election to defer withholding is available with respect to (1) interest on deposits with persons carrying on the banking business and (2) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization in respect of deposits or withdrawable or repurchasable shares. It is anticipated that the payor would be required to make this election with respect to all accounts of the same category.

Exemptions from withholding

The bill provides for six explicit exceptions to the withholding requirement on interest and dividends. These include an exception for (1) payments to certain low income and elderly individuals, (2) payments to other exempt recipients such as corporations and nominees, (3) certain payments by consumer cooperatives, (4) payments of small amounts of interest on United States saving bonds, (5) if the payor so elects, any payments which if made on an annual basis would aggregate less than $10 during the taxable year, and (6) payments by certain small financial institutions exempted by regulations issued by the Secretary.

Exempt individuals.—The bill provides for an exemption from withholding on payments to certain individuals. Specifically, payments to an individual who had no Federal income tax liability for the preceding year will be exempt from the withholding requirements if the individual files an exemption certificate with the payor. An individual 65 years of age or over will be exempt from the withholding tax if his income tax liability for the preceding taxable year was not more than $1,500 ($2,500 on a joint return). If either spouse filing a joint return is age 65 or over, then both spouses will be considered age 65 or over for this purpose. Under these exceptions, for example, a couple both of whom are over 65 and who use the standard deduction will be exempt from withholding unless their gross income exceeds approximately $22,214 (under 1984 tax rates).

Other exempt recipients.—The bill also provides that no withholding is required on payments to (1) a corporation, (2) an organization exempt from taxation under section 501(a) other than a farmers' cooperative organization described in section 521, (3) the United States or a State or local government (including a political subdivision, or agency or instrumentality thereof), (4) a foreign government or international organization, (5) a foreign central bank of issue, (6) a dealer in securities or commodities required to register as such under the laws of the United States or a State, (7) a real estate investment trust (as defined in section 856), (8) an entity registered at all times during the taxable year under the Investment Company Act of 1940, as amended, (9) a common trust fund (as defined in section 584(a)), or (10) a nominee or custodian except as otherwise provided in the regulations. A payment to such a person will be exempt if either the recipient provides the payor with an exemption certificate or the Secretary provides, by regulations, for exemption without certification. For example, the Secretary could provide that in certain circumstances the payor would be protected from liability if he relied on unequivocal evidence of the payee's status as an exempt recipient and did not withhold even though no exemption certificate is filed by the payee. Such evidence of a recipient's eligibility for exemption from withholding could include the identity of the payee as a governmental unit, or listing of the payee in Internal Revenue Service Publication number 78 as a charitable organization determined by the Internal Revenue Service to be exempt from tax.

Exemption certifications.—The bill requires the Secretary to provide a method by which exempt individuals and other exempt recipients of interest and dividend payments may at any time certify to their payor that withholding is not required on payments to them. The regulations providing for exemption certificates must provide rules governing (1) the form of the certification, (2) the time at which the certificates become effective, and (3) the transmittal of copies of the certificate to the Secretary. It is anticipated that the Secretary will require that the certificate contain a taxpayer identifying number that appears to be proper in order for the certificate to be effective. An exemption certificate, once filed, will remain in effect until: (1) the payee revokes the certificate, (2) the Secretary notifies the payor that the payee is not entitled to exemption, or (3) the Secretary notifies the payor that the payee's taxpayer identifying number is incorrect. The Secretary will also provide rules providing the payor with adequate time to respond to a change in the recipient's status as exempt or nonexempt.

Qualified consumer cooperative payments.—Under the bill, withholding is not required on any qualified consumer cooperative payment. Such a payment is any payment by a cooperative to which sections 1381 through 1388 apply and which the Secretary determines is engaged primarily in selling at retail goods and services of a type that are generally for personal, living, or family use and which the Secretary has exempted from the reporting requirements of section 6044(a) pursuant to the authority of section 6044(c).

Small savings bond interest payments.—The bill provides that any "small savings bond interest payment" will not be subject to withholding. Such a payment is any interest payment of $10 or less on the redemption of one or more United States savings obligations which the Secretary, by regulation, exempts from the interest withholding requirements. It is anticipated that the Treasury Department will continue the present practice of transmitting to the Internal Revenue Service interest earnings information by social security number.

Payments aggregating less than $10 on an annual basis.—The bill provides that the Secretary may prescribe regulations under which payors may elect not to withhold on payments of interest which on an annual basis would aggregate less than $10. Under this election, for example, a payor who paid interest quarterly would not have to withhold on payments to a payee of less than $2.50. This would be done even if the current payment added to preceding payments would exceed $10.

Credit for withheld amounts

Amounts deducted and withheld by withholding agents on payments of interest, dividends, and patronage dividends to individuals are allowed as a credit against the Federal income tax liability of the recipient for the taxable year beginning in the calendar year in which the withholding occurs under the same rules that apply with respect to the credit for income taxes withheld from wages.

In a case of electing small business corporations, actual distributions of dividends are subject to withholding, although constructive year-end dividend distributions are not subject to withholding. Generally, withholding on dividend distributions during any taxable year is creditable to the taxable year beginning in the calendar year in which withholding takes place. However, dividend distributions within two and a half months of the close of the taxable year of an electing small business corporation are treated as a distribution of undistributed taxable income for the preceding taxable year under the income tax. In this case, the credit for withheld tax is allowable for the taxable year of the recipient beginning in the calendar year in which the preceding taxable year of the corporation ended.

Amounts deducted and withheld from interest, dividends, or patronage dividend payments to estates and trusts are also creditable against income tax. Amounts withheld are first creditable against the tax of beneficiaries, and to the extent not considered withheld from beneficiaries, to the income tax of the trust or estate. Under regulations to be prescribed by the Secretary, withheld amounts will be allocated to each beneficiary of the estate or trust to reflect the amount by which amounts paid, credited, or required to be distributed to the beneficiary were reduced by the withholding.

Since withheld amounts are treated like amounts withheld on wages, the amounts withheld on interest, dividends and patronage dividends will reduce the taxpayer's estimated tax payment obligations. In addition, taxpayers will receive refunds of any amounts withheld that exceed liability for income tax in the same manner in which they receive refunds of excess withholding from wages.

Deposit of tax

Under present law, the Secretary is granted authority to prescribe the manner, times, and conditions under which deposits of any tax imposed under the Internal Revenue laws may be made with a depository or financial agent of the United States. In addition, the Secretary is authorized to determine the manner, times, and conditions under which receipt by such depositories of such tax will be treated as a payment of the tax to the Secretary. The committee intends that the Secretary will provide depository rules which will reflect the costs to withholding agents of establishing the withholding system.

Amounts subject to withholding

Interest.—Interest payments subject to withholding are payments of (1) interest on any obligation (other than any obligation with a maturity of not more than one year which is held by a corporation) which is issued in registered form, or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business, not including any amount paid on a depository institution tax exempt certificate, (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization in respect to deposits, investment certificates, or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c).

For purposes of the withholding provisions interest generally does not include any interest excluded from the definition of amounts subject to the information reporting requirements of section 6049. Thus, interest does not include (1) interest on any obligation issued by a natural person; (2) except as otherwise provided in regulations any amounts paid (a) to a State or local government, (b) to any tax-exempt organization, (c) to a corporation, and (3) to the extent provided in regulations any amount paid by or to (a) a foreign government, (b) an international organization, (c) a foreign central bank of issue, (d) a foreign corporation, or (e) a partnership not engaged in trade or business in the United States and composed in whole of nonresident aliens.

The definition of items excluded from interest subject to the reporting requirements is modified so that withholding is not required on any tax-exempt obligation of a State or local government under section 103(a) regardless of the date of issue. In addition, no withholding is required on interest paid on depository institution tax-exempt certificates (All Saver's Certificates). Further, interest subject to withholding does not include any amount which is subject to withholding of tax on nonresident aliens and foreign corporations and tax-free convenant bonds, or which would be required on such obligations, but for the fact that such amount is attributable to non-U.S. sources or that the payor is exempt from withholding by reason of section 1441(c) or a tax treaty.

Finally, interest subject to withholding does not include amounts paid by a foreign corporation or partnership composed in whole or in part of nonresident aliens not engaged in trade or business within the United States.

In general, original issue discount is taxable as interest to the extent includible in any holder's gross income tax during the taxable year. Similarly, original issue discount is subject to withholding to the extent it is includible in the gross income of any holder during the taxable year, subject to certain special rules.

In the case of original discount on evidences of indebtedness with a fixed maturity date not exceeding one year from the date of issue, no withholding is required until actual payment of that original issue discount on redemption. To the extent there are payments of coupon interest during the life of such a short term obligation, therefore, withholding is only required with respect to the coupon interest paid.

In the case of obligations with a fixed maturity date exceeding one year from the date of issuance, withholding is required with respect to the amount of original issue discount includible in the holder's income during the calendar year. The bill provides, however, that withholding on original issue discount will be made only out of amounts of cash actually paid, whether interest or principal. On redemption of a long-term discount obligation, the withholding will be based only on the amount includible in the holder's income during the calendar year in which redemption occurs. The Secretary may by regulation require withholding on original issue discount obligations in the absence of cash payments if he determines that the obligations are of a particular type that are frequently used in evading Federal taxes. Any such regulations, however, may only be effective with respect to obligations issued 30 days after regulations are promulgated.

In general, withholding on original issue discount obligations will be keyed to the difference between the issue price of the obligation and the stated redemption price at maturity.

For long-term original issue discount obligations issued after December 31, 1982, the bill's requirements that such obligations be issued in registered form will insure that the issuer, who will know the issue price of the obligations, will be in a position to determine the amounts of discount includible in the holder's income. Consequently, the proper amount of withholding tax can be computed. In computing the amount of original issue discount includible in income, subsequent holders of the obligation are treated like original holders. Premium paid on a purchase of a long-term obligation in the secondary market will be ignored for withholding purposes.

In the case of short-term discount obligations, the Secretary may by regulations base withholding on the difference between the holder's purchase price for the obligation and its stated redemption price at maturity. The vast majority of individuals acquire such obligations through a broker and arrange for the same broker to safekeep the obligation until maturity. With respect to these holders, the broker will have a record as to the amount of discount income. As a result, the broker will be in a position to withhold the correct amount of tax from the payment at maturity. In the less typical case when a short-term discount obligation is acquired from one broker and redeemed through another broker, the committee intends that a holder will be able to establish his purchase price for the obligation by means of records that are generally accepted on audit to establish basis. Thus, a confirmation receipt could be used by a holder, and relied upon by the broker, to establish his purchase price of the obligation. If a holder is, for any reason, unable to supply information as to his purchase price, the institution redeeming the instrument will be required to assume that he purchased the obligation at the issue price as indicated in standard financial sources. In the case of a Treasury bill, the purchase price will be assumed to be the average noncompetitive price of a 52-week bill with the same CUSIP number and the same maturity date as the bill in question. While overwithholding may result in some cases, the committee believes this is not a serious problem because the holder will receive a credit against his total tax liability and will be entitled to obtain a refund on any overwithheld taxes. More importantly, if the holder provides the required information, he may in all cases avoid overwithholding.

Dividends.—Dividends subject to withholding are (1) any distribution of property made by a corporation to its shareholders out of accumulated or current earnings and profits; (2) any payment made by a stockbroker to a person as a substitute for such a dividend. For this purpose the term "property" means money, securities, and any other property, except such term does not include stock in a corporation making a distribution or rights to acquire such stock.

In general, the term "dividend" does not include amounts which are not periodic in character or which are not taxable. Thus, the term dividend excludes any amount which is a qualified reinvested dividend (a distribution by a qualified public utility of shares of its qualified stock to an individual with respect to the common or preferred stock of such corporation, under the plan in which the shareholders may elect to receive stock as dividends instead of property); any amount treated as a taxable dividend by reason of section 302 (relating to a redemption of stock), any amount treated as a taxable dividend under the provisions of section 306 (relating to dispositions of certain stock), section 356 (relating to receipt of additional consideration in connection with certain reorganizations), or section 1081(e)(2) (relating to certain distributions pursuant to an order of the Securities and Exchange Commission); any amount which is a capital gain dividend distributed by a regulated investment company, or a real estate investment trust; any amount which is an exempt interest dividend of a regulated investment company; any amount paid or treated as paid by regulated investment company during the year if, under regulations prescribed by the Secretary, it is anticipated that at least 95 percent of the dividends paid or treated as paid during such year (not including capital gains distributions or exempt interest dividends). The term "dividend" does not include the year-end constructive distribution by an electing small business corporation of undistributed taxable income. In the case of an electing small business corporation, however, any payment of an amount within the first 2½ months of the taxable year, out of the corporation's undistributed taxable income for the previous taxable year is subject to withholding.

The term "dividend" also does not include any amount which is subject to withholding on certain income items paid to nonresident alien individuals, foreign partnerships, or foreign corporations; or any amount which would be subject to such withholding but for the fact that such amount is attributable to income from sources outside the United States or the payor is excepted from withholding by statute or tax treaty; or any amount paid by a foreign corporation not engaged in a trade or business in the United States.

In any case where the withholding agent is unable to determine the portion of a distribution which is a dividend, such withholding agent must withhold from the gross amount of the distribution as if it were entirely a dividend.

Patronage dividends.—For withholding purposes, patronage dividends are the amount of any patronage dividend which is paid by a cooperative in money, qualified written notice of allocation, or other property (except nonqualified written notice of allocation); and any amount paid in money, qualified written notice of allocation or property (except nonqualified written notice of allocation) paid by an exempt farmers' cooperative to patrons on a patronage basis with respect to earnings during the taxable year derived from business done for the United States or any of its agencies, or from nonpatronage sources; and amounts paid in redemption of either type nonqualified written notice of allocation described above.

The term "patronage dividend" does not include any amount which is subject to withholding on certain income items paid to nonresident alien individuals, foreign partnerships, or foreign corporations; or any amount which would be subject to such withholding but for the fact that such amount is attributable to income from sources outside the United States or the payor is excepted from withholding statute or by tax treaty; or any amount paid by a foreign corporation not engaged in a trade or business in the United States.

In determining the amount of any patronage dividend, property (other than a nonqualified written notice of allocation) shall be taken into account at its fair market value, and the qualified written notice of allocation must be taken into account at its stated dollar amount. The Secretary is provided with authority to determine under which conditions the withholding obligation imposed by this provision may be paid from an account or source other from the payment which gives rise to the liability for tax.

Per-unit retain allocations are not subject to withholding. For this purpose, a per-unit retain allocation is any allocation by a cooperative to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and patron. Unlike a qualified written notice of allocation, there is no requirement under the Code that a qualified per-unit retain allocation be paid at least 20 percent by qualified check. Therefore, there is no amount out of which withholding can be taken.

Information returns of withheld tax

Information returns with respect to payments of interest, dividends and patronage dividends subject to withholding must be made under the information reporting provisions of present law, as amended. Similarly, the payor is required to mail a statement to the payment recipient showing the total amount paid and amount withheld. To the extent the Secretary determines that attachment of such statement to the taxpayer's income tax return for the taxable year would aid in the administration of the tax laws, he may require that such statements be filed with such returns.

Failure to comply with these information reporting requirements is subject to the $50 penalties provided by the bill (increased from $10 in present law); and the increased penalty for intentional disregard of the filing requirements. Similarly, failure to file information statements with recipients is also subject to penalty. Additional withholding for failure to supply an accurate TIN will not apply.

Effective Date

This provision applies to payments made after December 31, 1982.

2. Expanded Reporting

a. Reporting of interest (sec. 311 of the bill and sec. 6049 of the Code)

Present Law

Reporting requirements

Under present law, every person who makes payments of interest aggregating $10 or more to any other person during the calendar year, or who receives payments of interest as a nominee and who then makes payments of interest aggregating $10 or more in any calendar year to any other person with respect to the interest so received must file an information return with the Internal Revenue Service. Such information returns must be filed with the Internal Revenue Service after September 30 (but not before the payor's final payment for the year), and on or before February 2 of the following year. These returns must set forth the aggregate amount of interest payments to the taxpayer and the taxpayer's name and address.

In addition, any corporation that has outstanding an obligation in registered form with respect to which $10 or more of original issue discount is includible in the gross income of any holder during any calendar year must file an information return with the Secretary. This return must report the aggregate amount includible in income by each holder of the discount obligation during the calendar year, the ratable monthly portion of the original issue discount, the issue price of the obligation, and the stated redemption price at maturity. These original issue discount information returns must be filed with the Internal Revenue Service after December 31 of the calendar year of accrual and on or before February 28 of the following year.

Payors of interest and persons who are required to file information returns with respect to original issue discount must also furnish information statements to recipients setting forth the aggregate amount of interest payments or original issue discount includible in income. Statements to recipients of interest must be furnished after November 30 (but not before the final interest payment for the year) of the calendar year and on or before January 31 of the following year. These statements may be furnished at any time after April 30 of the calendar year of payment if furnished with the final interest payment for the calendar year. Statements for original issue discount must be furnished after December 31 and on or before January 31 of the following year.

Definition of interest

For reporting purposes, present law defines interest as (1) interest on any evidence of indebtedness issued by a corporation in registered form; (2) interest on deposits with persons carrying on the banking business; (3) amounts paid by mutual savings banks, savings and loan associations, building and loan associations, coopérative banks, credit unions or similar organizations in respect to deposits, investment certificates or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) and interest on deposits with stockbrokers and securities dealers. In addition, the Secretary has regulatory authority (which has not been used) to provide that interest includes interest on evidences of indebtedness issued in other than registered form by a corporation of a type offered by corporations to the public.

The term interest does not include interest on State or local obligations exempt from tax under the Internal Revenue Code; interest on amounts paid by or to a foreign corporation, nonresident alien, or partnership composed in whole or part of nonresident aliens not engaged in a U.S. trade or business to the extent excluded from the definition of interest by regulation, and any amount paid with respect to a tax-free covenant bond where the person making the payment is required to deduct and withhold the tax, or would be so required but for any personal exemption claimed by the payee.

Reasons for Change

The committee believes that an expanded information reporting system with respect to the payment of interest is a necessary adjunct to the system of withholding on interest and dividends adopted in sec. 301 of the bill. First, an improved information reporting provision will assure that payments subject to withholding will be properly reported. Second, to make the withholding system fair and workable, certain exceptions have been made. For example, no withholding is required on payments to certain trusts and individuals. An expanded system of information reporting, which also entitles persons to notice of the amount of interest paid to them without regard to whether such amounts were subject to withholding, will assure that compliance is achieved on payments subject to these exceptions. Third, certain substantive changes in the tax law, including the amendments to the alternative minimum tax, require broader reporting of newly taxable income.

Explanation of Provision

Reporting requirement

Under the bill, every person who makes payments of interest aggregating $10 or more to any other person during the calendar year, who receives payments of interest as a nominee and makes payments of interest aggregating $10 or more in any calendar year to any other person with respect to the interest so received, or who withholds tax from a payment of interest must file an information return with the Secretary setting forth the aggregate amount of such payments, the amounts, if any, withheld, and the name and address of the person to whom paid or from whom withheld. Under the bill, as under present law, original issue discount is treated as paid (in the case of long-term obligations and bearer obligations issued after December 31, 1982) at the time includible in income, without regard to any reduction in the amount of original issue discount actually includible in income which results from a sale or other disposition of the discounted obligation. In the case of original issue discount on a bearer obligations issued before January 1, 1983, and original issue discount which is not includible in the income of a holder periodically (because, for example, the obligation has maturity of one year or less), the original issue discount is treated as paid on the earlier of redemption or maturity of the obligation. Similarly, acquisition discount on short-term government obligations is not subject to information reporting under these periodic inclusion rules. Under these rules, the amounts reported with respect to payees of original issue discount could be different from the amount, in fact, includible in the payee's income. The payor could indicate this fact to the payee.

Definition of reportable interest

Under the bill, interest subject to the information reporting requirement is defined to include (1) interest on any obligation (other than any obligation with a maturity (at issue) of not more than 1 year which is held by a corporation) which is issued in registered form, or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect to deposits, investment certificates, or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c); (6) interest paid on amounts held by investment companies and on amounts invested in other pooled funds or trusts, and (7) to the extent provided in regulations prescribed by the Secretary, any other interest (which is not specifically excluded from the definition of interest). These are generally the same categories of interest that are subject to reporting under present law except interest on all obligations in registered form or of a type offered to the public is subject to reporting rather than only interest on corporate obligations as under present law.

The definition of reportable interest is also expanded to include foreign source interest (*i.e.*, interest paid by a foreign governmental unit, agency, or instrumentality, a foreign corporation, nonresident alien or partnership not engaged in a U.S. trade or business composed in whole of nonresident aliens). Thus, the bill repeals the regulatory authority of the Secretary to except payments to certain partnerships composed in part of persons other than nonresident aliens. Additionally, the Secretary may not except interest paid through a U.S. collection agent or middleman to a United States person. For this purpose, the term "United States person" means a United States citizen or resident, a domestic partnership (organized under the law of the United States or any State), a domestic corporation, and any estate or trust other than a foreign estate or trust (sec. 7701(a)(30)). As in present law, the Secretary is granted authority to expand by regulations the information reporting requirement to include any interest.

Interest subject to reporting does not include interest on obligations issued by natural persons; interest on exempt governmental obligations issued before January 1, 1983; and, except as otherwise provided by regulations, any amount paid (1) to a State or local government or agency or instrumentality thereof, (2) to an exempt organization, or (3) to a corporation; (4) to a non-resident alien and (5) any amount with respect to which the payor is required to deduct and withhold a tax under the tax-free covenant bond provisions of the Code. Thus, interest on obligations described in section 103 issued after December 31, 1982, will generally be subject to information reporting.

The bill also provides that any financial institution, broker, or other person specified in regulations, acting as a middleman between the payor and the payee of interest may, under regulations, be required to file the information returns and statements required by this provision whether or not such middleman acts as a nominee. Such reports would be in lieu of reporting by any other person with respect to such interest. Thus, each person in the chain of payments between the payor and the ultimate payee need not file an information return or statement with respect to the same payment when regulations require one person in the chain to discharge the reporting obligations of all persons in the chain. For example, if a bank collects an interest coupon and makes payment thereon on behalf of the issuer, the regulations may require that the bank file the information return and statement and may relieve the actual payor of the interest of any obligation to file an information return.

The Secretary is also given regulatory authority to provide for reporting payments of interest by financial institutions, brokers and other middlemen on a transactional, rather than annual, aggregate basis. Under transactional reporting, the person reporting is obligated to report with respect to each transaction, rather than waiting until the end of the calendar year and reporting all transactions in the aggregate. A transaction is the payment at the same time of one or more obligations. For example, if a taxpayer presented five savings bonds each earning $3 of interest at one time, an information report would be required. However, if only three of the bonds were presented no report would be required even if the remaining two bonds were redeemed the following day.

As under present law, statements must be furnished to persons with respect to whom information is furnished to the Secretary. Such statements must be furnished on or before January 31 of the calendar year following the year of payment. However, if transactional reporting is allowed, information statements must be filed with the payee, under regulations, during January of the year following the calendar year of payment, or credit. Although the committee believes that statements of reported amounts should ordinarily be required to be furnished to payees during the tax filing season, the expense of such reporting for small amounts of interest outweighs the benefits of such reporting for compliance, particularly in the case of payments of less than $10 of interest on savings bonds. A statement must be furnished for any aggregate interest paid in the amount of $10 or more in any calendar year or on which tax has been withheld by the payor.

Effective Date

This provision is effective for amounts paid after December 31, 1982.

b. Obligations required to be registered (sec. 312 of the bill and secs. 103, 163, and 312 of the Code and new sec. 28 of the Second Liberty Bond Act)

Present Law

Under present law, the tax status of debt obligations is generally the same regardless of whether the obligation is issued in registered form or in bearer form. However, in the case of certain State and local obligations relating to housing or energy programs, interest on the obligations is exempt from Federal income tax only if the obligation is issued in registered form.

An obligation is in registered form if it is registered as to both principal and interest and if its transfer must be effected by the surrender of the old instrument and either the reissuance of that instrument by the issuer to the transferee, or the issuance of a new instrument by the issuer to the transferee. Unregistered (bearer) obligations may be transferred by delivery of the instrument to the purchaser.

Reasons for Change

The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

The committee also recognizes the importance of preserving liquidity in the financial markets. Thus, a flexible book-entry system of registration is permitted and exceptions from the registration requirements are provided for short-term obligations, for obligations of a type not offered to the public and for certain obligations issued abroad.

Explanation of Provision

Overview

The bill restricts the issuance of bearer obligations by imposing a direct prohibition on the issuance of bearer obligations by the United States and its agencies or instrumentalities and by denying certain tax benefits to issuers and holders of other bearer obligations issued after 1982. In addition, an excise tax is imposed on bearer obligations that are required to be issued in registered form. Exceptions to the registration requirements are provided for (1) obligations of a natural person, (2) obligations with a maturity at issue of not more than one year, and (3) obligations of a type not issued to the public and (4) certain obligations issued abroad.

Obligations of the United States

The bill amends the Second Liberty Bond Act to require that every "registration-required obligation" issued by the United States or any agency or instrumentality thereof (a U.S. obligation) must be in registered form. For this purpose, a registration-required obligation is any obligation other than an obligation of a type not offered to the public or with a maturity at issue of not more than one year or certain obligations issued abroad.

For this purpose, an obligation will be treated as issued in registered form if the right to principal of, and interest on, the obligation may be transferred only through a book entry consistent with regulations prescribed by the Treasury. It is anticipated that the present book-entry system used with respect to Treasury bills will constitute a proper registration system. When necessary, the Secretary may provide for maintenance of such book entries by an agent of the issuer or through a chain of one or more nominees.

An exception from the otherwise applicable registration requirement is provided for obligations of the United States if (1) interest on the obligation is payable only outside the United States, (2) the arrangements for issuance reasonably assure that the obligation will be sold (or resold in connection with its issuance) only to persons who are not United States persons (as defined in section 7701(a)(30)), and (3) under the terms of the obligation, no interest or principal is payable to any United States person.

Other obligations

Under the bill, obligations issued by persons other than the United States and its agencies and instrumentalities generally must be issued in registered form in order to avoid the denial of the interest deduction to the issuer and the imposition of an excise tax. For this purpose, a registration-required obligation is any obligation of a State or local government, except (1) an obligation of a type not offered to the public, and (2) an obligation with a maturity at issuance of not more than one year, and any obligation of another person (including an obligation of a foreign person or government), except (1) obligations issued by a natural person, (2) obligations not of a type offered to the public, (3) obligations with a maturity at issue of not more than one year, and (4) certain obligations issued abroad. Thus, most commercial paper is exempt from the registration requirements.

Generally, the same exception to the registration requirement for obligations issued and payable abroad is provided for non-United States obligations as is provided for obligations of the United States.

The Secretary is given authority to require registration of short-term and non-public obligations if, with respect to specific types of obligations, he determines that such obligations are used frequently to evade Federal taxes.

Sanctions against issuance of bearer obligations

If a registration-required obligation is not issued in registered form, no interest deduction is allowable to the issuer with respect to interest (including original issue discount) paid or accrued on the obligation. In addition, the earnings and profits of a corporation issuing a registration-required obligation in bearer form will not be reduced by the amount of any interest (including original issue discount) on the obligation. Moreover, if interest on an unregistered registration-required-obligation would otherwise be exempt from tax under the Code or any other provisions of law (for example certain State and local obligation), the exemption from tax will not apply. However, this rule does not override any treaty provision exempting interest from taxation by the United States. In addition to denying interest deductions, earnings and profits adjustments, and exemption for interest on impropertly issued bearer obligations; the bill would impose on issuance an excise tax on the issuer equal to one percent of the principal amount of the obligation multiplied by the number of years in the term of the obligation.

Definition of registered form

For purposes of these new rules, an obligation is in registered form if the right to principal and interest is transferable only through a book entry consistent with regulations issued by the Secretary. This book entry requirement will be satisfied by entries, consistent with regulations issued by the Secretary, on the books of any person holding an obligation in a street name or safekeeping an obligation for another, only if the ultimate beneficial owner of the obligation and its interest is determinable by way of the system. Thus, if obligation is issued in a street name to one person who then holds that obligation for another, the registration requirement will be satisfied by entries in the books of the safekeeper. It is anticipated that a system of book entries comparable to that used with respect to Treasury bills will satisfy the registration requirement. In addition, a small issuer could use an agent to maintain its book-entry system. If local law required the issuer to maintain its own registry, the issuer could, of course, issue a single registered obligation to its agent who could then re-issue the obligation in such a form that the ultimate beneficial owners can be identified. Finally, it is anticipated that the Secretary will require that such book-entry systems be maintained in a manner that will permit examination of the entries by the Secretary in connection with enforcement of the internal revenue laws.

Effective Date

These new registration requirements, and the associated sanctions for issuance of registration-required obligations in bearer form, will apply to obligations issued after December 31, 1982.

c. Returns of brokers (sec. 313 of the bill and sec. 6045 of the Code)

Present Law

Under present law, every person doing business as a broker must make a return, when required under regulations issued by the Secretary, showing customers' names and such details regarding profits and losses, and such further information, as the Secretary may require. There are, currently, no regulations under this section.

Reasons for Change

A preliminary Internal Revenue Service estimate for 1981 indicates that the compliance rate for capital gains reporting is below 60 percent. The committee finds this low compliance rate particularly objectionable because capital gains are generally realized by upper and middle income taxpayers. The committee believes that compliance in this area can be substantially improved by requiring that transactions carried out through brokers and other middlemen be reported to the Internal Revenue Service. At the same time, the committee recognizes the need to balance carefully the cost of reporting by brokers against the incremental improvement in compliance.

In addition, the committee believes that barter exchanges should be treated like brokers for purposes of this reporting requirement, as well as the third-party summonses rules.

Explanation of Provision

The committee bill modifies the present law rules relating to reporting by brokers in three respects. First, the bill permits the Secretary to require reporting of gross proceeds from transactions carried on by brokers for their customers in addition to, or in lieu of, details of profit and loss and such other information as the Secretary may require. Second, the bill requires persons making returns to the Internal Revenue Service as brokers to furnish statements of the information filed with the Internal Revenue Service to their customers on or before January 31, of the year following the calendar year for which the broker return is made. Third, the bill clarifies the definition of broker to explicitly include persons such as dealers, barter exchanges, and others who (for consideration) regularly act as middlemen with respect to property or services. For this purpose, a barter exchange is defined as any organization of members providing property or services who jointly contract to trade or barter such property or services. The term barter exchange does not include persons, such as wholesalers, who act for their own account. However, a broker or commodity dealer would be subject to the broker reporting requirement whether the sales effectuated for a customer were sales between the customer and a third party in which the broker acted as a middleman or sales between the broker and the customer in which the broker acted as a principal for its own account.

The bill specifically requires that regulations governing securities and commodity brokers and dealers under the amended broker reporting provisions be issued within six months after the date of enactment. These regulations would apply to transactions occurring after December 31, 1982. In prescribing such regulations, the committee expects that the Secretary will take into account industry practices in designing an efficient and workable system of reporting that is consistent with his statutory obligation to improve compliance with respect to the reporting of capital gains and other taxable transactions effected through brokers. In particular, to the extent practicable, the reporting system should be conformed to industry practices in maintaining brokerage activity records and should minimize broker data processing and storage costs. The bill gives the Secretary broad latitude in determining what information is appropriate and useful for reporting by brokers to the Internal Revenue Service and for furnishing information statements to the customers of brokers. For example, the Secretary could require reporting, on the basis of individual transactions, not only of gross proceeds of sale transactions but also conserving purchase transaction. In addition, the Secretary need not require reporting of transactions such as redemptions of money market shares of transactions carried out on behalf of other brokers or financial institutions.

The bill also extends the definition of third-party recordkeepers to include barter exchanges which are subject to the information reporting requirements imposed on brokers.

Effective Date

This provision will take effect on the day of enactment. Further, regulations must be issued under this provision within 6 months after the date of enactment, however, any such regulations may not apply to transactions occurring before January 1, 1983.

The provision locating barter exchanges as third-party recordkeepers is effective for summonses served after December 31, 1982.

d. Information reporting requirements for payments of remuneration for services and direct sales (sec. 314 of the bill and new sec. 6041A of the Code)

Present Law

Under present law, any person engaged in a trade or business generally must file an information return (Form 1099) with respect to payments to another person aggregating $600 or more in the calendar year (sec. 6041(a)). This reporting obligation, subject to various exceptions, applies to payments (whether made in cash or property) of salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income. Under current Treasury regulations, such payments made to corporations are exempted from this reporting obligation.

These information returns, which must be filed on an annual basis, generally must contain the name, address, and identification number of the recipient of the payments and the aggregate amount paid (secs. 6041(a) and 6109(a)). Recipients covered by this reporting requirement must furnish their name and address to the payor (sec. 6041(c)).

In addition, a payor required to file such an information return with the Internal Revenue Service also must provide the recipient with a statement which shows the payor's name, address, and identification number and the aggregate amount paid to the recipient during the year (sec. 6041(d), effective for returns required after 1981).

Present law does not contain specific information reporting requirements relating to direct sales of consumer products.

Reasons for Change

The committee believes that improvements in the information reporting provisions will increase the Internal Revenue Service's ability to administer and enforce the tax laws and will improve taxpayer compliance with the income and employment taxes. In addition, the committee has concluded that applying information reporting requirements with respect to certain direct sales of consumer goods will facilitate enforcement and compliance without placing undue burdens on direct sellers. Taking into account the structure of some direct selling organizations, the bill also provides two alternative methods of reporting with respect to these transactions.

Explanation of Provision

Payments of remuneration

The bill adds a separate provision (new Code sec. 6041A) specifically dealing with payments of remuneration for services.

Under this provision, a service-recipient (*i.e.*, a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.

Direct sales

General requirement

The bill also provides a new information reporting requirement for certain direct sellers. This requirement applies to any person engaged in a trade or business who in the course of such trade or business sells consumer products on a buy-sell basis, deposit-commission basis, or any similar basis specified in Treasury regulations[1] to any buyer who is engaged in either (1) selling such products in a home or otherwise than in a permanent retail establishment, or (2) selling those products to other persons so engaged.

Reporting on gross purchases for resale

Unless a direct selling business elects otherwise, it will be required to report gross purchases of consumer products for resale by any buyer purchasing $5,000 or more of such products in a calendar year. In addition, the business will be required to report commissions and other remuneration under the reporting provisions generally applicable to such payments.

Under the new requirement, the seller must file a return setting forth the aggregate amount of the purchases and the name, address, and identification number of the buyer. The seller also must furnish the buyer with a statement setting forth the name, address, and identification number of the seller, and the aggregate amount of purchases by the buyer. The fact that a buyer purchases some of the products for personal use or consumption, rather than for resale, has no effect on the applicablility of the reporting requirement. However, purchases of goods that cannot be resold, such as catalogues and samples, need not be reported.

Elective requirement

In lieu of reporting gross purchases of consumer products for resale, a direct seller may elect to be subject, instead, to the bill's alternative reporting requirements. If a direct seller makes the election, then the threshold for reporting commissions and other renumeration will be payments aggregating $50 or more in the calendar year (rather than the generally applicable threshold of $600 or more). In addition, a direct seller electing this alternative requirement must file a return identifying all buyers to whom aggregate sales of $250 or more are made during the calendar year. This return must set forth the buyer's name, address, and identification number, but not the amount of purchases by the buyer. The seller also must furnish the buyer with a statement reporting the filing of this return with the Internal Revenue Service.

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[1] A transaction is on a buy-sell basis if the buyer is entitled to retain the difference between the price at which he or she purchased the product and the price at which the product is sold as part or all of the buyer's remuneration for reselling the seller's products. A transaction is on a deposit-commission basis if the buyer is entitled to retain a purchase deposit paid by the consumer as part or all of his or her remuneration.

Effective Date

The information reporting requirements in new Code section 6041A generally apply to payments made after December 31, 1982. However, the reporting requirements for direct sales apply to sales after December 31, 1983.

e. Reporting of State and Local Income Tax refunds (sec. 315 of the bill and sec. 6050E of the Code)

Present Law

Under present law, the refund, credit or offset of State or local income taxes that were deducted (with a resulting tax benefit) in a prior year is includible in a taxpayer's gross income.

There is no requirement that information returns with respect to such refunds be filed with the United States or that refund recipients receive information statements with respect to such refunds during the tax-filing season. Twelve States, however, provide such information to the Internal Revenue Service under voluntary information exchange agreements.

Reasons for Change

The committee believes that requiring information reporting on state and local income tax refunds, including reporting to individual taxpayers will remind taxpayers of the proper treatment of refunds and provide them with helpful information during the tax-filing season. The committee does not believe it necessary to extend such reporting to taxpayers other than individuals because of the higher compliance rates for such taxpayers.

Explanation of Provision

The committee bill provides that an information return must be filed with the Secretary with respect to any State or local income tax refunds, credits, or offsets aggregating $10 or more paid or credited to an individual during the calendar year. The year in which an offset or credit is reported is the year in which the liability of the State to payover or credit the amount is admitted by the State. Thus, if an amount is credited to reduce the future liability of the taxpayer, it is reportable once credited even though the liability has not yet arisen. Such return must report the aggregate amount of any such refund payments, credits, or offsets, and the recipient's name and address. State and local governments can satisfy their return obligations under this provision through voluntary information exchange agreements (such as those now currently in effect between the United States and 12 states).

In addition, the provision requires that a statement with respect to each return be furnished to the recipient of the refund, credit or offset during January of the calendar year following the calendar year in which the refund is made or the credit or offset allowed.

Effective Date

This new requirement will apply to refunds paid, and credits or offsets allowed, after December 31, 1982.

f. Reporting of tips (sec. 316 of the bill and sec. 6053 of the Code)

Present Law

Under present law, any employee who receives, in any calendar month and during the course of his employment, any tips which are wages or compensation, must report all such tips to his employer on or before the 10th day following the month of receipt. Tips are defined as wages or compensation to the extent they are paid in cash during any calendar month, are $20 or more in amount, and are received by an employee in the course of his employment. Such wages are deemed paid at the time a written statement including such tips is furnished to the employer by the employee, or, if no statement including such tips is furnished, at the time received.

In general, withholding for purposes of the Federal Insurance Contributions Act (FICA) tax and the income tax is required only to the extent tips are reported to the employer and only to the extent collection of the tax can be made by the employer from wages paid to the employee (excluding tips, but including funds turned over by any employee to the employer or under the control of the employer). Generally, if the FICA and income tax withholding obligations exceed the amount of wages and other amounts turned over to the employer, the excess must be paid by the employee. The employer must furnish a written statement to the employees showing the amount of such excess.

Present law also imposes substantial recordkeeping requirements upon tipped employees and employers. In general, employees whether or not they receive tips are required to keep records to establish the amount of gross income and deductions. Because tips are includible in income, employees must keep records of all tips received and of all deductible tips paid to other employees. Employers are expressly required to retain only charge tip receipts and statements of tips received by employees furnished by such employees. Failure to maintain such records may subject employees or employers to penalties (sec. 6653).

Reasons for Change

The compliance rate with respect to tip income is approximately 16 percent according to preliminary estimates by the Internal Revenue Service with respect to 1981 based upon date furnished by the Bureau of Economic Analysis of the Department of Commerce. Thus, 84 percent of the taxes on tip income is not paid. The only type of income with a lower compliance rate is illegal income which has a compliance rate of only 5 percent.

The committee believes that such low compliance rates are fundamentally unfair to wage earners and other taxpayers with substantially higher levels of voluntary compliance. Expanded information reporting on tip income will encourage better reporting of such income by its recipients and facilitate Internal Revenue Service efforts to increase compliance in this area. At the same time, the committee recognizes that improved compliance rules should not impose unnecessary recordkeeping obligations on taxpayers or employers.

Explanation of Provision

The bill retains the rules of present law relating to reporting of tips to employers by their employees and to the resulting withholding of FICA and income taxes. However, to assist the Internal Revenue Service in its examinations of returns filed by tipped employees, the bill provides a new set of information reporting requirements for large food and beverage establishments. These establishments will be required to report to the Internal Revenue Service (1) the gross receipts of the establishment from food and beverage sales (other than receipts from carryout sales), (2) the amount of charge receipts (other than from carryout sales), (3) the aggregate amount of tips shown on such charge receipts and (4) each employee's allocable share of an amount (representing assumed tip income) equal to seven percent (other than from carryout sales). The seven percent amount will be allocated among tipped employees in proportion to their respective shares of all tips received by tipped employees of the establishment. The precise allocation will be made either as the employees and employer mutually agree or in the absence of agreement as the employer determines. Both the agreement and the employer determination must, of course, be made in good faith by the parties. If the employees of an establishment report tips in an aggregate amount equal to or exceeding the seven percent amount, the employer need only report the amount of tips reported to the employer.

The allocation of the seven percent amount to employees for reporting purposes will have no effect on the FICA or income tax withholding responsibilities of the employer or on his FUTA obligations. Thus, employers will continue to withhold only on amounts reported to them by their tipped employees. Of course, the allocation also has no effect on the actual entitlement of the employer or employee to gross receipts or tip income. Similarly, this purely informational report to the Internal Revenue Service will not affect the requirements of the Fair Labor Standards Act or any collective bargaining agreement.

The seven percent figure reflects the committee's judgment that the tip rate in establishments subject to this reporting requirement will rarely be below the seven percent level. Thus, an employee who reports less than his allocated amount of tips must be able to substantiate his reporting position with adequate books and records as he must under present law. The Internal Revenue Service could prove that tipped employees received a larger amount of tip income. For example, as under present law, the Internal Revenue Service could show from charge tip rates that a particular establishment had a higher tip rate than seven percent.

A large food or beverage establishment is any establishment (public or private) the activity of which is the provision of food or beverages for consumption on the premises, other than of a "carry-out" nature such as "fast food restaurants," with respect to which tipping is customary, and which normally employed more than 10 tipped employees on a typical business day during the preceding calendar year. The Secretary will prescribe regulations for the application of this 10-employee rule in the case of new businesses. Thus "fast-food" restaurants would not generally be subject to the new reporting requirement. Restaurants that provide table or counter service for seated customers, and employ 10 or more persons, and cocktail lounges with similar service, are large food or beverage establishments. An establishment may be part of a larger operation such as a hotel. Each large food or beverage establishment must provide an information statement, according to regulations, to each employee for each calendar year setting forth the employer's name, the employee's name, and the amount of the employee's allocation of the 7 percent over the aggregate amount reported to the employer as tips by the employee during the calendar year. It is anticipated that the information statement concerning allocated tips could be integrated into Form W–2 now supplied by employers with respect to wages.

Effective Date

The amendments made by this section apply to calendar years beginning after December 31, 1982.

3. Provisions To Improve Reporting Generally

a. Increased penalties for failure to file information returns (sec. 321 of the bill and sec. 6652 of the Code)

Present Law

Present law imposes a penalty on any person who fails to file, on the date prescribed (with extensions), information returns, including returns relating to (1) payments by any person engaged in a trade or business of $600 or more in any taxable year of rent, salaries, premiums, annuities, and certain other types of fixed and determinable gains, profits, and income; (2) payments of dividends aggregating $10 or more in any calendar year; (3) payments of patronage dividends aggregating $10 or more in any calendar year; (4) payments of interest aggregating $10 or more in any calendar year; (5) payments of certain fishing boat operators in any calendar year; (6) income tax withheld, or (7) payments of wages in any calendar year in the form of group-term life insurance. The penalty is $10 for each such failure, but the total amount of the penalties imposed for all such failures during a calendar year cannot exceed $25,000. The penalty is not imposed if the failure is due to reasonable cause and not due to willful neglect. Present law also imposes specific penalties on failure to file other types of information returns.

Reasons for Change

The committee believes that inadequate information reporting of non-wage income is a substantial factor in the underreporting of such income by taxpayers. In many cases, persons who are required to make information reports do not do so because they consider the informational forms unimportant or the cost of their processing is more than the cost of the penalty that might be incurred for failure to comply with the filing requirements. The committee believes that the current penalty and the way it historically has been applied does not reflect the importance of timely filed information returns to the administration of the tax laws.

Explanation of Provision

The bill expands the category of information returns subject to the generally applicable penalty for failure to timely file information returns, raises the basic penalty and creates a new second tier penalty for intentional failures. Information returns newly subject to the penalty are (1) those information returns with respect to transactions carried out by brokers for their customers, (2) information returns with respect to direct sellers that are not subject to the new penalty for failure to file information returns relating to independent contractors, and (3) all information reports with respect to interest subject to the new information reporting provisions. For example, a taxpayer who fails to receive a reminder of amounts received may inadvertently omit them from his income. Next, the bill increases the penalty for failure to file most information returns to $50 per failure. The total amount of penalties for all such failures for any calendar year is not to exceed $50,000, increased from $25,000 under present law.

The bill provides that when the failure to file information returns is due to intentional disregard of the filing requirements, the penalty will not be less than 10 percent of the aggregate amount of the amounts not properly reported and the $50,000 limitation will not apply. In the case of an information return required to be filed by a broker under section 6045, the penalty is not less than 5 percent of gross proceeds required to be reported, without regard to the $50,000 limitation. Because brokers are required to report proceeds from sales, the lower percentage of amount is intended to provide a roughly comparable penalty to that provided for information reports of income. In the case of returns relating to direct sellers, the intentional disregard penalty will be $100 for each failure to report a direct seller's name and address.

Although the committee is aware that the penalty for failure to file information returns has been little used in the past, it intends that the Internal Revenue Service will use this increased penalty more fully to protect the information reporting and withholding systems.

Effective Date

The provision applies to returns the due date of which (without extensions) is after December 31, 1982.

b. Increase in civil penalty on failure to supply identifying numbers (sec. 322 of the bill and sec. 6676 of the Code)

Present Law

Present law imposes a penalty of $5 per failure on any person who is required by regulations (1) to include his taxpayer identification number (TIN) in any return, statement or document, (2) to furnish his TIN to another person, or (3) to include in any return or statement made with respect to another person the TIN of such other person, and who fails to comply with such requirement at the time prescribed. The penalty is not imposed if the failure is due to reasonable cause and not due to willful neglect. In practice, this penalty is rarely, if ever, imposed. The failure to impose the penalty helps explain why 11 percent of all information returns contain missing or inaccurate TINs.

Reasons for Change

The committee believes that the present amount of the penalty for failure to supply TINs does not properly reflect the importance of these numbers to an efficient system of tax collection. The absence of a for the Internal Revenue Service to verify and match the proper reporting of income on the tax return of the taxpayer concerned. The committee believes that further perfection of the matching process by increased accuracy in the reported TINs will tend to increase taxpayer compliance in properly reporting income from all sources. Thus, the committee believes that the basic penalty for failing to supply a TIN should be increased. The committee believes that such failures are equally serious if committed by a third-party recordkeeper, by a taxpayer in failing to supply a third party with his TIN, or by the taxpayer in his failure to furnish his TIN on a return.

Explanation of Provision

The committee bill increases the penalty for failure to supply identifying numbers from $5 per failure to $50 per failure. The maximum penalty that can be imposed in any calendar year will be limited to $50,000.

In addition, the bill provides that if any failure to include the TIN of another person in any return or statement made with respect to that other person is due to the intentional disregard of the requirements to include such other person's TIN in the return, the penalty will be $100 per failure and the $50,000 limitation will not apply. Thus, for example, if a person is penalized for failure to provide TINs in one year and repeats that failure in the next year, the penalty may be doubled and the $50,000 limitation removed.

Effective Date

The provision will be effective for payments made after December 31, 1982.

c. Extension of withholding to certain payments where identifying number not furnished or inaccurate (sec. 323 of the bill and sec. 3402(s) of the Code)

Present Law

Present law imposes a penalty of $5 per failure on any person who is required by regulations (1) to include his taxpayer identification number (TIN) in any return, statement, or document, (2) to furnish his TIN to another person, or (3) to include in any return or statement made with respect to another person the TIN of such other person, and who fails to comply with such requirement at the time prescribed. The penalty is not imposed if the failure is due to reasonable cause and not due to willful neglect. In practice, this penalty is rarely, if ever, imposed.

Reasons for Change

The absence of a correct TIN on an information return often makes it difficult and expensive for the Internal Revenue Service to match and verify the proper reporting of income on the tax return of the taxpayer concerned. The bill increases the basic penalty for failing to supply a TIN. The committee believes that if a taxpayer fails to supply his correct TIN to another person withholding should be imposed to assure that taxpayers comply with the income tax laws.

Explanation of Provisions

The committee bill provides for withholding at source at a tax rate of 15 percent if a taxpayer fails to supply a TIN or supplies an incorrect TIN to another person who must file certain types of information returns with respect to payments to the taxpayer. The types of payments subject to this withholding requirement include: (1) payments of rents, salaries, wages, commissions, fees, or other forms of compensation for services and other fixed or determinable gains, profits, or income including payments to independent contractors; (2) payments of dividends; (3) payment of patronage dividends; (4) payments of interest; (5) payments of certain fishing boat operators; and (7) payments by brokers. Withholding will not be required on payments in kind of patronage dividends and fishing boat operators. This withholding will not apply to any payment on which withholding is required by another provision of the Code. In addition, this withholding will not apply to such payments made to the United States or any agency or instrumentality thereof, to any State or political subdivision thereof, to any tax-exempt organization, or to any foreign government or international organization. Finally, the bill requires the Secretary to provide for exemptions from the backup withholding provisions during periods in which a person is awaiting receipt of an identification number.

This new 15-percent withholding will apply to covered payments if the taxpayer (payee) fails to supply a TIN, or supplies an obviously incorrect TIN, or if the Secretary notifies the payor that the taxpayer's TIN is not correct. If no number is given or an obvious incorrect number is provided, then the withholding obligation applies immediately and continues until an apparently correct number is provided. For this purpose, an obviously incorrect number is a number which is sequential or uniform or which contains the wrong number of digits (including any number which includes alpha characters rather than digits). If the Secretary notifies the payor that the payee's TIN is incorrect, then the withholding requirement applies on the eighth day following notification and continues until a new number is provided by the payee. If the payee has twice provided an incorrect number, then the payor must continue to withhold until the Secretary notifies the payor that the number provided by the payee is correct. Although the committee believes that notice is generally appropriate before withholding is begun, the failure to provide a TIN that is *prima facie* correct or repeated failures to provide a correct TIN signal a breakdown in the information reporting system of sufficient magnitude that an immediate response is necessary.

The payor is provided seven days in which to correct its records and stop withholding after a new number is provided (or confirmed by the Secretary) and may begin withholding after notification of an incorrect number prior to the eighth day following notification. These grace periods are provided to allow payors to adjust to the withholding requirement and to protect them from any possible liability for wrongful withholding in the period immediately preceding or following a period during which withholding is required.

Except in the case of payments of compensation, etc. for which information reporting is required under section 6041 (relating to information at the source generally) or section 6041A (relating to payments to independent contractors), this requirement for withholding applies without regard to the reporting thresholds provided for the information returns. The committee adopted this rule because it was understood to be more easily administratable by payors than a withholding system which tracks the exemption amounts of the information reporting rules. For example, if a taxpayer fails to provide a TIN to the payor of an interest payment that is not subject to flat-rate withholding and is less than $10, this backup withholding provision will apply even though no information report would be required until more than $10 were paid. In the case of payments of compensation etc., subject to reporting under sections 6041 or 6041A, backup withholding would not be required unless (1) the aggregate of payments made after withholding is required and all prior payments during the calendar year equal or exceed $600, (2) the payor was required to file an information return with respect to the payee under section 6041 or 6041A for the preceding calendar year, or (3) the payor made payments to the payee during the preceding calendar year on which backup withholding was required.

The bill also requires that if the Secretary notifies the payor that a TIN is incorrect, a copy of the notice must also be furnished to the payee. This notice may be furnished by mailing it to the address of the payee shown on the return provided by the payor or, in the absence of such an address, by mailing the notice to the payee in care of the payor.

Generally, payment of amounts subject to this new withholding provision will be treated as wages paid by an employer to an employee and subject to the various provisions applying to collection of income tax at the source on wages.

Effective Date

This provision will apply to payments made after December 31, 1983.

d. Penalties for failure to provide information with respect to payments of remuneration for services and direct sales (sec. 321 of the bill and new sec. 6660 of the Code)

Present Law

For most types of information returns, the penalty for failure timely to file returns, or to provide recipients with statements, is $10 for any one such failure, with a maximum aggregate penalty for each type of failure of $25,000 for any one calendar year (secs. 6652(a) and 6678). No penalty is imposed, however, if the failure is due to reasonable cause and not due to willful neglect.

Reasons for Change

The committee is concerned that the present-law penalties for failures to file information returns, and furnish statements to payees, with respect to compensation paid to nonemployees are insufficient to effect appropriate levels of compliance. The committee believes that increasing the penalty for failure to furnish information will have a salutary effect on compliance and will enhance the level of reporting.

The committee's bill imposes two levels of penalties with respect to failures to comply with the information reporting requirements—a basic penalty for such failures and a doubling of the basic penalty in the case of intentional or reckless disregard of the law. The committee believes that structuring the penalty in this manner will provide a further inducement to compliance.

Explanation of Provision

Basic penalty

The bill adds a new penalty for noncompliance with the requirements for filing information returns or furnishing statements regarding payments for services or direct sales. The new penalty is imposed if a person (1) fails to file timely a required return regarding payments made to another person for services rendered by such other person or regarding direct sales to another person; (2) fails timely to furnish a statement to such other person regarding such return; or (3) fails to include on any return or statement the entire amount required to be included.

For each failure with respect to an information return or statement regarding payments for services, the penalty is one percent for each month while the failure continues (but not to exceed five percent) of the amount required to be included on the return or statement but not so included. In the case of each failure regarding information returns and statements on gross purchases from direct selling businesses, the penalty is one-fifth of one percent per month, but not to exceed one percent of the amount not included.

Double penalty

The penalty is doubled where the failure to comply with these requirements is due to intentional or reckless disregard of the law. If there is either intentional or reckless disregard of the law, then for each failure with respect to an information return or statement regarding payments for services, the penalty is two percent per month (but not to exceed ten percent) of the amount required to be included on the return or statement but not so included. In the case of reporting of gross purchases by direct selling businesses, the penalty is two-fifths of one percent per month, but not to exceed two percent of the amount not included on the information return or statement.

Minimum penalty; exception

The minimum penalty in either type of case (payments for services or direct sales) will be $50. No penalty applies if a failure is due to reasonable cause and not to willful neglect.

Interim period for regulatory exceptions

Because the bill creates a new statutory provision regarding payments of compensation for services, the regulatory exceptions applicable to the existing statutory reporting requirements for such payments (e.g., payments to corporations) will not automatically apply. Until new regulations are issued and businesses are afforded an appropriate period of time to comply with any new requirements, the committee believes it would be inappropriate to impose penalties for any failure to comply with reporting requirements that are subject to specific regulatory exceptions under existing law. This grace period should in no event extend, however, to payments made after December 31, 1983.

Statute of limitations exception

The bill provides a new exception to the general statute of limitations provisions with respect to failures to file information returns or to furnish statements of payments for services and direct sales. Under the bill, the Internal Revenue Service generally may not assess the new penalty unless it was assessed, or a proceeding to collect it had begun, within six years after the last date (with extensions for filing) for filing the return or statement. The committee believes that it is appropriate to restrict the statute of limitations in this special situation because of the increased penalties provided by the bill and the increased recordkeeping burdens imposed upon payors and direct sellers.

Effective Date

The new penalty provisions generally apply to payments made after December 31, 1982. Penalties imposed on direct sellers apply to sales made after December 31, 1983.

e. Minimum penalty of extended failure to file (sec. 325 of the bill and sec. 6651 of the Code)

Present Law

Under present law, if a taxpayer fails to file a tax return on the date prescribed (with extensions of time for filing), a penalty is imposed based on the amount of any underpayment of tax for the year. The penalty is 5 percent of the underpayment per month, or fraction thereof, while the failure continues, but not more than 25 percent in the aggregate. Thus, no penalty is imposed on the taxpayer if there is no underpayment for the year or if a refund is due. Likewise, no penalty is imposed if the failure is due to reasonable cause and not due to willful neglect.

Reasons for Change

Over 5 million taxpayers failed to file required returns last year. When a person fails to file a tax return, the Internal Revenue Service is put to the expense of seeking out such person and determining whether he owes tax. At present, it costs the Internal Revenue Service over $75 on average to identify a non-filer. When the taxpayer owes no tax or is entitled to a refund, no penalty applies. The committee believes that the obligation of taxpayers to file timely returns should be backed up with a penalty, and that such penalty should not be entirely inapplicable merely because the taxpayer has no additional tax liability. Failure to file a timely return is a clear violation of the tax law.

Explanation of Provision

This provision adds a new minimum penalty for the extended failure to file any income tax return. If an income tax return is not filed within 60 days of the date prescribed (with extensions), the penalties for failure to file will not be less than $100. This minimum penalty is not imposed if the failure to file the return was due to reasonable cause.

Effective Date

The penalty would apply to returns due after December 31, 1982.

f. Form of returns (sec. 326 of the bill and sec 6011 of the Code)

Present Law

In general, returns required by the tax laws must be made according to the forms and regulations prescribed by the Secretary. As a general rule, these returns must be in written form except that in certain cases the return may be made by filing the required information on magnetic media or other medium, provided that the prior consent of the Commissioner is obtained. There is no statutory or regulatory requirement that any particular return be filed on magnetic media or in other machine-readable form. Under the case law, the Internal Revenue Service has not been successful in arguing that a statement of income, deductions and tax liability presented in irregular form but containing all the necessary information does not constitute a "return."

Reasons for Change

An essential part of any plan to improve compliance is improving the Internal Revenue Service's ability to quickly and accurately process and cross-match the information it receives. Such processing and cross-matching can be expedited and processing costs substantially reduced if returns and other information filed with the Internal Revenue Service are filed: (1) in complete (processible) form, and (2) in machine-readable form. The Internal Revenue Service will have increased capability in the future to process returns filed in machine-readable form. In addition, filings of irregular compilations of tax materials needlessly delay tax administration. The committee understands that in the most recent year for which statistics are available, 14,500 reporters filed 200 or more information returns each on paper, thus adding over 2,900,000 paper documents to the Internal Revenue Service's document processing burden.

Explanation of Provision

The provision requires that the Secretary prescribe regulations providing standards for determining which returns must be filed on magnetic media. In providing these standards, the Secretary is directed to take into account, among all other relevant factors, the ability of the taxpayer to comply, at a reasonable cost, with such a filing requirement.

Under this authority, for example, the Secretary could require persons filing multiple information returns (such as wage statements or interest information returns) to file such returns on magnetic media when the basic data from which the returns are generated is already maintained in a computer. Similarly, the Secretary could require use of paper forms that could be subject to optical character scanning. In addition, the Secretary could impose a general requirement for use of magnetic media in certain circumstances but provide a mechanism for case-by-case exemptions from the requirement. The regulations issued by the Secretary may not prohibit the filing of income tax returns by individuals, trusts, or estates on paper forms provided by the Secretary.

Effective Date

This provision would be effective upon enactment.

4. Abusive Tax Shelters

a. Penalty for promoting abusive tax shelters, etc. (sec. 331 of the bill and new sec. 6700 of the Code)

Present Law

Present law contains no penalty provision specifically directed toward promoters of abusive tax shelters and other abusive tax avoidance schemes. When a promoter organizes or sells a tax shelter that is premised on misrepresentations of the tax law, the existence of the investment assets, or the value of property or services, the promoter may, in the appropriate case, be subject to (1) civil penalties for the preparation or presentation of a false or fraudulent return or other document as a return preparer, or (2) the criminal penalties for aiding, assisting in, procuring, counseling or advising the preparation or presentation of a false or fraudulent return or other document under the internal revenue laws or for willfully attempting to evade or defeat a tax imposed under the internal revenue laws.

Reasons for Change

As of September 30, 1981, 248,828 returns with tax shelter issues were in the examination process, according to the 1981 Annual Report of the Commissioner of Internal Revenue. This represents an increase of 74,584 returns of this type over the prior fiscal year. The widespread marketing and use of tax shelters undermines public confidence in the fairness of the tax system and in the effectiveness of existing enforcement provisions. These tax schemes place a disproportionate burden on the Internal Revenue Service resources.

The committee believes that the penalty provisions of present law are ineffective to deal with the growing phenomenon of abusive tax shelters. Abusive tax shelters must be attacked at their source: the organizer and salesman. The committee recognizes that the Securities Exchange Commission has powers that may be directed toward some tax shelter promoters but believes Internal Revenue Service enforcement in this area will materially contribute to a solution of this problem in a number of ways. For example, the Internal Revenue Service can be expected to approach the problem with vigor since prevention of abusive shelter promotions will require less manpower than enforcement actions against numerous investor-taxpayers. In addition, if the Internal Revenue Service establishes fraud by a promoter, the investors may be materially aided in their efforts to seek rescission of the contracts under which they invested. Finally, the promoter penalty is particularly equitable because the promoter, professional advisor or salesman of a tax shelter is generally more culpable than the purchaser who may have relied on their representatives as to the tax consequences of the investment.

Explanation of Provision

The bill imposes a new civil penalty on persons who organize, assist in the organization of, or participate in the sale of any interests in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangements when, in connection with such organization or sale, the person makes or furnishes either (1) a statement which the person knows is false or fraudulent as to any material matter with respect to the availability of any tax benefit alleged to be allowable by reason of participating in the entity, plan or arrangement, or (2) a gross valuation overstatement as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed. A gross valuation overstatement is any statement or representation of the value of services or property which exceeds 400 percent of the correct value of the property or services and which is directly related to the amount of any income tax deduction or credit allowable to any participant. Although the valuation error must be even more substantial than that required before a penalty applies to the investor, the committee believes that such a limited penalty will prevent any unintended application. The penalty for gross valuation overstatement will have no effect on bona fide commercial or investment transactions in which, for example, a willing and knowledgeable buyer purchased from a willing and knowledgeable seller for cash because such a purchase price will define the value of the investment. A matter is material to the arrangement if it would have a substantial impact on the decision making process of a reasonably prudent investor.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. There need not be reliance by the purchasing taxpayer or actual underreporting of tax. These elements have not been included because they would substantially impair the effectiveness of this penalty. Thus, a penalty could be imposed based upon the offering materials of the arrangement without an audit of any purchaser of interests. If the Internal Revenue Service cannot determine the entire amount of the gross income from an activity, it may assess the penalty on the portion of such gross income that may be determined. In determining the penalty with respect to the amount of gross income yet to be derived from an activity, the Secretary may look only to unrealized amounts which the promoter or other person may reasonably expect to realize.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith. The mere existence of an appraisal is not sufficient, by itself, to show either reasonable basis or good faith. Rather, the Secretary may, for example, examine the basis for the appraisal, the manner in which it was obtained, and the appraiser's relationship to the investment or promoter.

This penalty is in addition to all other penalties provided for by law.

Effective Date

This section will take effect on the day after the date of enactment.

b. Action to enjoin promoters of abusive tax shelters etc. (sec. 332 of the bill and new sec. 7408 of the Code)

Present Law

Present law provides that a civil action may be brought by the United States to enjoin any person who is an income tax return preparer from (1) engaging in any conduct subject to penalty under the income tax return preparer provisions or under the criminal tax laws, (2) misrepresenting his qualifications, (3) guaranteeing a refund or credit, or (4) engaging in any other fraudulent or deceptive conduct that substantially interferes with the proper administration of the tax laws. Venue for such an action lies in the district in which the income tax return preparer resides or has his principal place of residence, or the taxpayer with respect to whose income tax return the action is brought resides. Injunctive relief may be granted by the district court if the court finds that such relief is appropriate to prevent recurrence of the prohibited conduct.

In addition to its power to seek injunctions against persons violating the return preparer provision, the United States is empowered to seek, and the district court of the United States to grant, such decrees or orders, and processes (including injunctions) as may be necessary to enforce the internal revenue laws (sec. 7402(a)).

Reasons for Change

The bill provides for a penalty on promoters of investments with abusive positions (see sec. 331 of the bill described, above). The committee believes that the most effective way in which this new penalty can be enforced is through injunctions against violators to prevent recurrence of the offense. The ability to seek injunctive relief will insure that the Internal Revenue Service can attack tax shelter schemes years before such challenges would prove possible if the Internal Revenue Service were required to await the filing and examinations of tax returns by investors. Thus, injunctive relief will better enable the Internal Revenue Service to protect the integrity of the tax laws and to protect potentially innocent investors against widespread marketing of such tax schemes.

Explanation of Provision

The committee bill permits the United States to seek injunctive relief against any person who is engaging in conduct subject to the penalty for organizing or selling abusive tax investments (sec. 331 of the bill and new Code sec. 6700). Under the bill, these actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to penalty under section 6700. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

The Court may grant injunctive relief against any person if it finds (1) that the person has engaged in any conduct subject to the penalty for organizing or selling abusive tax investments, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct.

An injunction granted under this provision may prohibit the person enjoined from engaging in any activity subject to penalty under new section 6700. Of course, the court will continue to have full authority to act under its general jurisdiction (section 7402) and will continue to possess the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief. For example, a court could enjoin particular conduct or enjoin all conduct violative of new section 6700. In addition, the court could enjoin any action to impede proper administration of the tax law or any action which violates criminal statutes. See, e.g., *United States* v. *Landsberger*, 534 Fed. Supp. 534 (D. Minn., Dec. 14, 1981).

The commencement of any action under this provision does not in any way restrict the right of the United States to commence or carry on any other action against the organizer or seller.

Effective Date

The amendment would take effect on the day after the date of enactment.

c. Procedural rules applicable to penalties under sections 6700, 6701, and 6702 (sec. 333 of the bill and new sec. 6703 of the Code)

Present Law

Under present law, the burden of proof is on the Secretary in any proceeding in which the issue is whether an income tax return preparer has willfully attempted to understate the liability for tax of any person (*i.e*, violated section 6694(b)). Similarly, the burden of proof is generally on the Secretary to prove fraud. Under present law, the deficiency procedures generally apply to the collection of additions to tax, additional amounts, and nonassessable penalties. Thus, jurisdiction is generally in the Tax Court to redetermine such additions to tax, additional amounts, and nonaccessable penalties prior to their assessment and collection.

Generally, except in the case of certain return preparer penalties (sec. 6694(c)), district court review of additions to tax, additional amounts or penalties (whether or not assessable), is not available before such amounts are fully paid. Exceptions to the rule exist when an assessment is desirable or when the statute specifically provides for district court review. In the case of a penalty imposed under the income tax preparer provisions, no levy or proceeding in court may be prosecuted to collect such penalty if, within 30 days after notice and demand the income tax return preparer pays 15 percent of such penalty and files a claim for refund of the amount paid. If the claim is denied or ignored, the income tax return preparer may file a suit in the district court to determine his liability for the penalty. During the pendency of such action, the statute of limitations on collection of such amount is suspended.

Reasons for Change

The committee believes that the new penalties on (1) promoters of abusive tax investments, (2) persons assisting in the presentation of false or fraudulent documents under the Internal Revenue laws, and (3) persons filing frivolous returns should be subject to the same procedural safeguards as the existing penalties on income tax return preparers.

Explanation of Provision

The bill provides for district court review of the Secretary's assessment and notice and demand of (1) the abusive tax investments promoter penalty (sec. 331 of the bill), (2) the civil aiding and assisting penalty (sec. 342 of the bill), or (3) the frivolous return penalty (sec. 343 of the bill), before the full amount of such penalties may be collected when certain procedural requirements are met. The review procedures are generally similar to those now provided with respect to the income tax return preparer penalties.

Thus, while the deficiency procedures do not apply to these penalties, and the penalties are immediately assessable, provision is made for review of the Secretary's assessment and notice and demand of such penalties if within 30 days after notice and demand of the penalty is made, the taxpayer pays 15 percent of the demanded amount and files a claim for refund. If the claim for refund is denied or ignored, the taxpayer may file suit in the district court to determine his liability for the amount claimed. No levy or proceeding to collect such penalty may be made during such 30-day period or if the taxpayer pays the 15 percent and files a claim for refund, until the claim is finally disposed of, either administratively or by final resolution of any district court review proceeding instituted by the taxpayer. For purposes of this provision, the final resolution of any proceeding will generally occur when the decision of the district court is final. If the taxpayer fails to bring a timely action in the district court, the Secretary may proceed to collect the full amount of the penalty.

In any proceeding involving the issue of whether any taxpayer is liable for the tax shelter promoter penalty, the civil aiding or assisting penalty, or the frivolous return penalty, the burden is on the Secretary to prove the conduct giving rise to the penalty.

As in the case of the income tax return preparer penalties, the statute of limitations for collection of the amount assessed is suspended during the time the Secretary is prohibited from collecting the penalty under this provision.

Effective Date

Amendments made by this provision take effect on the day after the date of enactment.

5. Substantial Underpayments; False Documents; Frivolous Returns

a. Penalty for substantial understatement (sec. — of the bill and new sec. 6701 of the Code)

Present Law

Under present law, a penalty is imposed on the failure to pay certain taxes shown on a return (or if not paid within 10 days of notice and demand, an amount of tax required to be shown on a return) unless it is shown that such a failure to pay is due to reasonable cause and not willful neglect. If any portion of an underpayment of tax is due to negligence or intentional disregard of rules and regulations (negligence) but without intent to defraud, the addition to tax is equal to 5 percent of the entire underpayment. In addition, if the negligence penalty applies, an additional amount equal to 50 percent of the interest payable on that portion of the underpayment due to negligence, for the period running from the last date prescribed for payment of the tax (determined without regard to extensions) to the date the tax is paid, is imposed.

If any portion of an underpayment is due to fraud, then an addition to tax equal to 50 percent of the underpayment is imposed and (in the case of the income and gift taxes) the negligence penalty cannot be imposed. Further, if the fraud penalty is imposed, no penalty for failure to timely file a return may be imposed. Reasonable reliance on the advice of a tax advisor generally will prevent application of the fraud and negligence penalties.

In 1981, the Congress enacted a "no-fault" penalty on valuation overstatements. Under that penalty, if a taxpayer makes a large error in placing too high a value on property which results in an understatement of tax, then a penalty measured as a percentage of the underpayment resulting from the valuation overstatement is imposed. Although the penalty is imposed without regard to fault, the Secretary may waive all or part of the penalty if there was a reasonable basis for the valuation and it was claimed in good faith. This penalty does not apply in the case of an undervaluation of services.

Reasons for Change

The committee believes that an increasing part of the compliance gap is attributable to the "audit lottery." The audit lottery is played by taxpayers who take questionable (although non-negligent) positions not amounting to fraud or negligence on their returns in the hope that they will not be audited. If a taxpayer is audited and the questionable position is challenged, then he or she pays the additional tax owing plus interest. Importantly, however, taxpayers are not exposed to any downside risk in taking highly questionable positions on their tax returns since even resolution of the issue against the taxpayer will require only payment of the tax that should have been paid in the first instance with interest to reflect the cost of the "borrowing." Taxpayers rely on opinions of tax advisors to avoid the possibility of fraud or negligence penalties in taking these highly questionable positions, even though the advisor's opinion may clearly indicate that if the issue is challenged by the Internal Revenue Service, the taxpayer will probably lose the contest. Thus, in the event that the questionable position is not detected, the taxpayer will have achieved an absolute reduction in tax without cost or risk. The committee believes, therefore, that taxpayers should be subject to a penalty designed to deter the use of undisclosed questionable reporting positions. On the other hand, the committee recognizes that taxpayers and the Government may reasonably differ over the sometimes complex Federal tax laws, and that a penalty is not appropriate for in many cases in which there is a large underpayment. Finally, the committee believes that taxpayers investing in substantial tax shelters should be held to a higher standard of reporting or risk a significant penalty.

Explanation of Provision

In general, under the committee bill, when there is a substantial understatement in income tax for any taxable year attributable to an aggressive filing position not disclosed by the taxpayer in the return, or taken by the taxpayer with respect to a tax shelter, an addition to tax equal to 10 percent of such understatement will be imposed.

For this purpose, an understatement is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. A substantial understatement of income tax exists if the understatement for the taxable year exceeds 10 percent of the tax required to be shown on the return for the taxable year; and $5,000 ($10,000 for corporations other than subchapter S corporations and personal holding companies). Thus, for example, in 1982, married couple filing jointly would not be subject to the penalty unless they have taxable income in excess of approximately $27,900 and report no tax liability whatever. Similarly, a corporation would need an income of approximately $30,300 (in 1982) before it could be subject to the penalty. The committee believes it is appropriate to thus exclude low and moderate income taxpayers from the scope of the penalty both because of the greater access of higher income taxpayers to sophisticated tax advice and because these taxpayers appear more often to play the audit lottery.

The amount of any understatement must be reduced, however, by any portion of the understatement attributable to the treatment of any item (1) with respect to which the taxpayer had a subjective belief that such treatment was more likely than not to be sustained if the issue were challenged and litigated; or (2) which is adequately disclosed in the return or an attachment thereto. A taxpayer could establish such belief by showing good faith reliance on a professional opinion that the taxpayer was more likely than not ultimately to prevail in any contest with the Internal Revenue Service. An item is disclosed if it is disclosed in such a way as to apprise the Secretary of the nature of the controversy surrounding the item and amount of such item. The committee bill provides broad regulatory authority to permit the Secretary to prescribe the form of disclosure. However, the committee intends that the Secretary shall in no event require disclosure of accountant's work papers. Instead, disclosure will be made if the taxpayer discloses facts sufficient to enable the Internal Revenue Service to identify the potential controversy, if it analysed that information. For example, if a taxpayer has only a reasonable basis that an amount received was a business gift and therefore not includable in income, he may avoid a penalty by attaching a readily identifiable statement to his tax return disclosing the amounts received and the name and business relationship of the payor. Also, a taxpayer taking a bad debt deduction in a particular year, when there is a question as to the correct year in which the loss is allowable, could avoid the penalty by disclosing the issue to the Secretary. However, the disclosure exception to the understatement definition does not apply to any item derived from a tax shelter. A tax shelter is any partnership or other entity, an investment plan or arrangement, or any other plan or arrangement the principal purpose of which (based on the objective evidence) is the avoidance or evasion of the Federal income tax. The committee determined that a disclosure defense was inappropriate for tax shelter items because a higher standard of reporting for such items should be imposed. Also, committee received substantial testimoney that additional disclosure is not necessary for tax shelters.

In determining the amount of the addition to tax under this provision, that portion of the understatement which would be subject to the penalty on valuation overstatements is not taken into account. The Secretary can waive all or part of the penalty if the taxpayer shows that there was a reasonable basis for the understatement and that he acted in good faith. A waiver would be appropriate, for example, if the taxpayer made a good faith mistake in deciding the proper timing of a deduction.

Effective Date

This penalty would apply to returns due after December 31, 1982 (without regard to extensions).

b. Penalties for aiding and abetting the understatement of tax liability (sec. 342 of the bill and new sec. 6701 of the Code)

Present Law

Present law provides a criminal penalty for willfully aiding, assisting in, procuring, counseling, or advising the preparation or presentation of a false or fraudulent return, affidavit, claim, or other document under the internal revenue laws. The criminal penalty is punishable by a fine of up to $5,000 or 3 years imprisonment, or both, together with costs. The term "document" has been broadly interpreted in other contexts to include such items as matchbook covers submitted to the Tax Court (*Stein* v. *United States*, 363 F.2d 587 (5th Cir. 1966), and affidavits supplied to the Internal Revenue Service during a criminal investigation (*United States* v. *Johnson*, 530 F.2d 52 (5th Cir. 1976), cert, denied, 429 U.S. 833).

The criminal penalty has been interpreted to apply to a variety of cases, including a race-track "10 percenter" who was convicted of filing a false Form 1099 even though the taxpayer's own name, address, and taxpayer identification number appeared on the return (*United States* v. *Snyder*, 549 F.2d 171 (10th Cir. 1977)), the preparer of false information returns for exempt organizations (*Beck* v. *United States*, 298 F2d 622 (9th Cir. 1962))), and floor brokers in foreign exchange operations who provided false information to a taxpayer and, therefore, participated in the preparation of a fraudulent tax return (*United States* v. *Siegel*, No. 79 CR 606, N.D. Ill. (June 27, 1979), 79-2 U.S.T.C.¶9698).

There is no comparable civil penalty on persons who aid or assist in the preparation or presentation of false or fraudulent documents. However, income tax return preparers who willfully attempt to understate the liability for tax of any person are subject to a penalty of $500 per return.

Reasons for Change

The committee believes that a new civil penalty analogous to the criminal penalty for aiding and abetting in the preparation of presentation of a false return or document is necessary for the four reasons. First, the penalty will permit more effective enforcement of the tax laws by discouraging those who would aid others in the fraudulent underpayment of their tax. Second, it is inappropriate to impose sizeable civil fraud penalties on taxpayers but to allow the advisors who aid or assist in the underpayment of tax to escape civil sanctions. Third, the committee recognizes that certain types of conduct should be penalized but are not so abhorent as to suggest criminal prosecution. Finally, the committee believes the new penalty will help protect taxpayers from advisors who seek to profit by leading innocent taxpayers into fraudulent conduct. It is anticipated that the Internal Revenue

Service and Justice Department will continue to vigorously pursue the prosecution of criminal violations of the tax laws, including conduct subject to this new penalty.

Explanation of Provision

The bill provides for a new civil penalty on any person who aids, assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document under the internal revenue laws which portion the person knows will be used in connection with any material matter arising under the tax laws, and which portion the person knows will (if used) result in any understatement of the tax liability of another person.

No person will be subject to this penalty unless that person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document under the tax laws, or directly procures a subordinate to do any act punishable under this provision. Thus, for example, if a person prepares a schedule or other portion of a return which portion was, in all respects, correct, that person will not be subject to this penalty even if he or she knows that other portions of the return he or she does not help prepare and over which he does not have any control is fraudulent. The penalty does not apply to any person who merely furnishes typing, reproducing or other mechanical assistance in the preparation of the return, etc.

The term "procures" includes ordering or otherwise causing a subordinate to do an act subject to this penalty, or knowing of and not attempting to prevent participation of a subordinate in an act subject to this penalty. The term "advises" includes acts of independent contractors such as attorneys and accountants in counseling a particular course of action. A "subordinate" is any person, including an agent, over which the taxpayer has direction, supervision, or control. Direction, supervision, or control for this purpose includes only direct and immediate direction, supervision, and control.

The burden of proof in imposing the penalty is on the Secretary. In addition, all the other procedural rules described in section 333 of the bill apply to this penalty.

In general, this penalty is in addition to all other penalties provided by law. However, if any of the return preparer penalties may apply with respect to any document, the penalty does not apply with respect to such document.

This penalty, which is $1,000 for each return or other document ($5,000 in the case of returns and documents relating to the tax of a corporation) can be imposed whether or not the taxpayer knows of the understatements. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to the taxpayer's actions in assisting any one person. Thus, someone who assists two individuals in preparing false documents would be liable for a $2,000 penalty whereas the penalty would be only $1,000 if he had advised in the preparation of two false documents for the same taxpayer.

Effective Date

This provision is effective on the day after the date of enactment.

c. Penalty for frivolous returns (sec. 343 of the bill and new sec. 6702 of the Code)

Present Law

Under present law, a taxpayer who files a protest return (such as one refusing to pay tax because the U.S. is no longer on the gold standard) may be subject to a penalty for failure to file a return, or for negligence or fraud. These penalties, however, are measured as a percentage of the underpayment of tax. Thus, if a taxpayer has paid at least the correct amount of tax through estimated tax or wage withholding, there is no penalty for filing a protest return. In addition, even when there is an underpayment, it may take several years of administrative and judicial proceedings before any penalty is imposed.

Reasons for Change

The committee is concerned with the rapid growth in deliberate defiance of the tax laws by tax protestors. The Internal Revenue Service had 13,600 illegal protest returns under examination as of June 30, 1981. Many of these protestors are induced to file protest returns through the criminal conduct of others. These advisors frequently emphasize the lack of any penalty when sufficient tax has been withheld from wages and encourage others to play the "audit lottery." The committee believes that an immediately assessable penalty on the filing of protest returns will help deter the filing of such returns, and will demonstrate the determination of the Congress to maintain the integrity of the income tax system.

Explanation of Provision

The bill provides that an immediately assessable penalty of $500 will be imposed on any individual who files any document which purports to be a return of income tax if (1) the document fails to contain information from which the substantial correctness of the amount of tax shown on the return can be judged or contains information that on its face indicates that the amount of tax shown on the return is substantially incorrect, and (2) such conduct arises from a position taken by the taxpayer on the purported return which is frivolous, or from a desire (which appears on the face of the purported return), to delay or impede the administration of the Federal income tax laws. The penalty will be imposed, therefore, only on purported returns that are patently improper and not in cases involving valid disputes with the Secretary. This penalty will not be imposed, of course, in the case of innocent or inadvertent mathematical or clerical errors (as defined in sec. 6213(g)(2)(A) or (B)), including certain incorrect uses of tax tables, etc.

For example, the penalty under this provision is immediately assessable against any individual who files, as a purported Form 1040, a document appearing at first glance to be a Form 1040, but which contains altered or incorrect descriptions of line items or other altered provisions. Such purported "returns" are clearly not designed to inform the Secretary of the filer's taxable income and are not in processible form. The penalty will be immediately assessable against any individual filing a "return" in which many or all of the line items are not filled in except for references to spurious constitutional objections. Furthermore, the penalty is available against any individual filing a purported return in which insufficient information to calculate the tax is given or where the information given is clearly inconsistent (as where an individual claims 99 exemptions but lists only a few dependents) or where the return otherwise reveals a frivolous position or a desire to impede the tax laws. Morover, the penalty could be imposed against any individual filing a "return" showing an incorrect tax due, or a reduced tax due, because of the individual's claim of a clearly unallowable deduction, such as a "gold standard deduction" (i.e., a discount of dollars because the U.S. is not on the gold standard) or a "war tax" deduction under which the taxpayer reduces his taxable income or shows a reduced tax due by that individual's estimate of the amount of his taxes going to the Defense Department budget, etc. In contrast, the penalty will not apply if the taxpayer shows the correct tax due but refuses to pay the tax. In such a case, of course, the Secretary can assess and collect the tax immediately. The penalty will not be imposed, however, if the taxpayer merely inadvertently fails to use the correct tax table, or makes inadvertent mathematical errors on his or her return, if, however, the taxpayer deliberately uses incorrect tax tables, for example, to impede the tax system and that use otherwise satisfies the penalty requirements, the penalty will apply.

Because it is unnecessary to determine the taxpayer's true tax liability before imposing the penalty, the penalty is immediately assessable. The deficiency procedures, under which the taxpayer would receive advance notice before assessment, do not apply to this penalty. There is, however, a provision allowing for district court review of the assessment on payment of 15 percent of the amount assessed and the filing of a claim for refund of the amount paid (see sec. 333 of the bill). This district court review is not one with respect to the taxpayer's actual liability for any tax for the taxable year. It is merely a determination of whether the penalty under this provision was properly imposed. The district court's opinion cannot, therefore, have any res judicata or collateral estoppel effect on the issue of the taxpayer's actual tax liability for the taxable year. This penalty is in addition to all other penalties provided by law.

Effective Date

This penalty will apply to documents filed after the date of enactment.

d. Relief from criminal penalty for failure to file estimated tax where a taxpayer falls within statutory exceptions (sec. 344 of the bill and sec. 7203 of the Code)

Present Law

Individuals

In general, under present law, any single person, or a married couple with one earner entitled to file a joint return, whose gross income is expected to exceed $20,000 for the taxable year must declare and pay estimated tax. In addition, any married individual entitled to file a joint return whose gross income is expected to exceed $10,000 for the taxable year (if both spouses receive wages), and any married individual not entitled to file a joint return whose gross income is expected to exceed $5,000 must also declare and pay estimated tax. Furthermore, an individual taxpayer who expects to receive more than $500 from sources other than wages during the year is required to file a declaration of estimated tax. An individual who fails to pay in full an installment of estimated tax on or before the due date may be subject to a civil penalty.

There are four exceptions to the general underpayment penalty. No penalty is imposed if: (1) total payments of estimated tax (withholding plus estimated tax payments) exceed the preceding year's tax liability, if a return showing liability for tax was filed for the preceding year and such preceding year was a taxable year of 12 months; (2) total estimated tax payments generally exceed 80 percent of the taxes which would be due if the income already received during the current year were placed on an annual basis; (3) total tax payments equal 90 percent of the tax which would be due on the income actually received from the beginning of the year to the end of the month before the month in which the installment is due, as if such months constituted the taxable year; or (4) total tax payments equal the tax based on the facts shown on, and the law applicable to, the prior year's return under the current year's tax rates and exemptions.

Corporations

Under present law, any corporation subject to tax is required to make payments of estimated tax if it reasonably expects to have an estimated tax liability for the taxable year of $40 or more. The estimated tax is payable in up to four installments over the taxable year.

In general, if the amount of any estimated tax payment is not equal to the installment which would be requested to be paid if the estimated tax were equal to 80 percent of the actual tax due, then a penalty is imposed. There are three exceptions to the estimated tax penalty on corporations these are discussed under item B, 15, above.

Criminal penalty

In the case of both individuals and corporations, present law imposes a criminal penalty for willful failure to pay any estimated tax at the time required by law. A person convicted for such willful failure is guilty of a misdemeanor and may be fined not more than $10,000 or imprisoned not more than 1 year (or both), together with the costs of prosecution. This criminal penalty may apply even if no civil penalty can be assessed because one of the exceptions listed above is satisfied.

Reasons for Change

The committee believes the criminal penalty should expressly not apply when no civil penalty attaches to the underpayment of estimated taxes. The committee believes that the proposed change merely codifies present law.

Explanation of Provision

The committee bill provides by statute that any individual or corporation that fails to make any estimated tax payment, or underpays any estimated tax payment, is not subject to the criminal penalty for such failure if the civil penalty for such failure is not applicable because an exception to the civil penalty applies.

Effective Date

This provision is effective on the date of enactment.

6. Administrative Summonses

a. Special procedures for third-party summonses (secs. 351 and 352 of the bill and sec. 7609 of the Code)

Present Law

Under present law, if an administrative summons is served on a third-party recordkeeper summoning that person to produce the records made or kept by the third-party recordkeeper with respect to the business transactions or affairs of a person other than the person summoned, then notice of the summons must also be given to the person whose records have been summoned (the taxpayer) within 3 days of the day on which the summons was served but not less than 14 days of the day fixed to examine the records. Such notice must be accompanied by a copy of the summons served and must contain directions and materials on how the taxpayer can stay compliance with the summons. For these purposes, a third-party recordkeeper is a bank or similar financial institution; a consumer reporting agency; a credit card company; a brokerage house; an attorney; or an accountant.

The taxpayer can stay compliance with a third-party summons, if the taxpayer notifies the recordkeeper in writing, not later than the 14th day after the day notice is given, not to comply with the summons and mails a copy of this notice to the Secretary by registered or certified mail. To enforce the summons, the Secretary must then seek an order of a United States District Court compelling compliance, at which time the third-party recordkeeper or the taxpayer must assert its defenses for noncompliance. Unless the taxpayer staying compliance consents, no examination of the summoned records can be made until the expiration of the period for notice not to comply or, if such notice is given, until the court authorizes examination.

To enforce third-party recordkeeper summonses, the Secretary must meet the requirements set out by the Supreme Court in *United States v. Powell*, 379 U.S. 48 (1964). Thus, the Secretary must show that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps required by the Code have been followed.

In addition, the Service must at all times use its summons authority in good faith pursuant to the Congressionally authorized purposes described in section 7602. Under present law, these purposes are (1) ascertaining the correctness of any return, (2) making a return where none has been made, (3) determining the liability of any person, for any internal revenue tax, or (4) collecting any such liability. A summons, including a third-party summons, is authorized only for those prescribed purposes. Pursuant to such a purpose, a summons may be issued to summon a person liable for tax or required to perform the act, or any person having possession, custody, or care of the books of account of such a person, or to summon any other person the Secretary deems proper to appear before the Secretary and to produce such records or give such testimony as is relevant to the inquiry. In general, a summons issued to determine the identity of a person having a numbered account (or similar arrangement) with a bank or similar financial institution, or in aid of the collection of tax from a person against whom an assessment has been made or judgment rendered, or in aid of the collection of tax from a transferee or fiduciary of a person against whom an assessment has been made, is not treated as a third-party recordkeeper summons.

A summons which does not identify the person with respect to whom the summons is issued may be served only after the Secretary establishes in court that the summons relates to an investigation of a particular person or group or class of persons, that there is a reasonable basis for believing that such person may fail or may have failed to comply with any provision of the internal revenue law, and that the information sought to be obtained is not readily available from other sources.

The notice provisions applicable under present law to the issuance of a third-party summons do not apply if a court determines, pursuant to a petition of the Secretary, that reasonable cause exists to believe that such notice may lead to attempts to conceal, destroy, or alter records, or to prevent the communication of information from other persons to the Secretary, or to attempts to flee the jurisdiction of the Secretary.

Under present law, there is no requirement that third-party recordkeepers immediately proceed to assemble summoned records.

Reasons for Change

The present law rules relating to summonses of third-party recordkeepers were enacted in 1976 to protect the rights of persons whose records are held by third parties. The automatic stay provisions enacted in 1976 have been so easy to use that taxpayers have frequently delayed enforcement of summonses without considering the merit of any objection they might have. As a result, the Internal Revenue Service prevails in the vast majority of actions it brings to enforce third-party summonses. Indeed, most taxpayers fail to contest the summonses when the Internal Revenue Service seeks enforcement.

The committee believes that shifting the burden of commencing litigation with respect to the validity of a third-party recordkeeper summons will eliminate most of the frivolous delay permitted under present law without adversely affecting the rights of taxpayers.

Delay also occurs under present law because recordkeepers hesitate to incur the expense of complying with summonses until they are certain that the taxpayer has not contested the summons. The committee believes that recordkeepers should prepare to comply as soon as possible, and that recordkeepers should be protected from liability for wrongful disclosure when the Internal Revenue Service certifies that the taxpayer is not contesting the summons.

At the same time the committee believes that barter exchanges ought to be granted status as third-party recordkeepers.

Explanation of Provision

Rights to seek to quash summons

Under the bill, a taxpayer whose records are summoned and who is, therefore, entitled to notice of the summons and who wishes to prevent compliance with the summons by the recordkeeper, must begin a civil action in court to quash the summons not later than the 20th day after the day after notice of the summons is given.[2] Subject only to the local rules of the relevant Federal district court, the directions and materials provided with the summons should enable the taxpayer to make the filing to quash the third-party summons.

If the taxpayer initiates a proceeding to quash the summons, the taxpayer is required to mail (by registered or certified mail) a copy of the petition to the recordkeeper, and a copy to the Secretary, within this 20-day period.

The committee intends that all matters relating to the third-party summons will be resolved by the court in any proceedings instituted by the taxpayer under this provision. Thus, the Secretary could use this occasion to seek to compel compliance with the summons.

The recordkeeper has the right to intervene in the proceeding to quash the summons, and is bound by any decision in such proceeding, even if it does not intervene.

No examination of the summoned records is allowed before the close of the twenty-third day after notice is given (17th day under present law), or if a proceeding to quash is begun, until the court so orders. Jurisdiction with respect to such actions resides in the district court where the summoned person resides or is found. Generally, venue in such a case will be in the judicial district where summons is served on the third-party recordkeeper. An order of the district court denying the petition to quash the summons is a final, appealable order. No change is made by the provision with respect to appeals and the conditions under which stays of enforcement may be granted because the committee believes the relatively strict attitude adopted by the courts under present law is appropriate and that the rules governing appeals and stay should continue to be developed in a flexible manner by the courts.

Although an action to quash the summons must be instituted by the taxpayer, the ultimate burden of persuasion with respect to its right to enforcement of the summons will remain on the Secretary, as under current law. Thus, the Secretary will have to meet all the requirements of *United States* v. *Powell*, 379 U.S. 48 (1964), including a showing that the individual investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to that purpose, that the information sought is not already within the Commissioner's possession, and that all the administrative steps required by the Code have been followed. As a defense to the enforcement of the summons, the taxpayer may show that the taxpayer's case has been referred to the Department of Justice (see, Limitation on Use of Administrative Summonses, sec.   of the bill).

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[2] Under present law, the taxpayer has until the end of the 14th day after the day notice of the third-party summons is given to notify the third-party recordkeeper not to comply with the summons.

Duty of third-party recordkeepers

The bill requires third-party recordkeepers to proceed to assemble summoned records upon receipt of the summons and to be prepared to produce the records on the date specified for their examination. Thus, the recordkeeper is not permitted to wait until after the 20-day period in which the taxpayer would have the right to seek to quash the summons before assembling the summoned records. Of course, such recordkeepers may be entitled to reimbursement for its costs under section 7610 regardless of whether or not the summons is enforced. After expiration of the 23-day period, the bill permits the Secretary to certify to the recordkeeper that no proceeding to quash had been initiated. Any recordkeeper who makes a disclosure of records pursuant to a court order or in reliance on the Secretary's certification that no proceeding to quash had been commenced is not liable to the taxpayer for the disclosure.

Effective Date

The provisions are applicable with respect to summonses initially served after December 31, 1982.

b. Limitation on use of administrative summonses (sec. 353 of the bill and sec. 7602 of the Code)

Present Law

Under present law, the Secretary may issue summonses for the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person (including transferees or fiduciaries) for any internal revenue tax, or collecting any such liability. In pursuit of one of these purposes, the Secretary is authorized to examine any books, records, *etc.*, which may be relevant or material to such an inquiry; to summon the person liable for the tax, or required to perform the act or any officer or employee of such person, or any third-party recordkeeper, or any other person the Secretary may deem proper, to produce such books, records, *etc.*, or give such testimony under oath as may be material or relevant to such inquiry.

In order to enforce an administrative summons, the Secretary must meet the requirements of *United States* v. *Powell*, 379 U.S. 48 (1964) and *United States* v. *LaSalle National Bank et al*, 437 398 (1978). Under *Powell*, the Secretary must show that (1) the investigation will be relevant to that purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps required by the Code have been followed. In addition, the Secretary must at all times use the summons authority in good faith in pursuit of the Congressionally authorized purposes described in section 7602.

Reasons for Change

Under *LaSalle*, the Secretary may not use an administrative summons once the internal Revenue Service has referred a case to the Department of Justice for prosecution or has made an institutional commitment to refer a case to the Department for criminal prosecution. This rule has spawned protracted litigation without any meaningful results for the taxpayer. Yet, summons enforcement proceedings should be summary in nature and discovery should be limited. See *United States* v. *Kis*, 658 F.2d 526 (7th Cir. 1981). Therefore, the restrictions under present law on the use of administrative summonses once the Internal Revenue Service has made an institutional decision to abandon pursuit of a civil tax determination or collection, or has made an institutional commitment to refer a case to the Justice Department, have encouraged wasteful litigation.

Many tax investigations by the Internal Revenue Service have both civil and criminal aspects. The committee believes that a clear definition of when the power to issue an administrative summons exists and when it does not exist in cases with a criminal aspect will simplify administration of the laws without prejudicing the rights of taxpayers. To permit the drawing of a clear distinction, it was necessary to expand the purposes for which an administrative summons may be issued by the Internal Revenue Service.

Explanation of Provision

Under the bill, the Secretary may not issue any summons or commence any action to enforce a summons if a Justice Department referral is in effect with respect to the person whose tax liability is in issue. A Justice Department referral is in effect with respect to any person if the Secretary recommends to the Attorney General (1) a grand jury investigation or (2) criminal prosecution of such person for any offense connected with the internal revenue laws, or (3) the Attorney General (or Deputy Attorney General or Assistant Attorney General) makes a written request to the Secretary for return of or return information relating to a taxpayer which request sets forth the need for disclosure for tax administration purposes. A Justice Department referral ceases to exist when the Attorney General notifies the Secretary, in writing, that he will not prosecute such taxpayer for any offense connected with the administration or enforcement of the internal revenue laws; that he will not authorize a grand jury investigation of such person with respect to such offense; that he will discontinue any such grand jury investigation; that a final disposition has been made of any criminal proceeding pertaining to the enforcement of the internal revenue laws which was instituted by the Attorney General against such taxpayer; or the Attorney General, Deputy Attorney General, or Assistant Attorney General notifies the Secretary, in writing, that he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws relating to any written request for return or return information. Each taxable period (or, in the case of excise taxes, each taxable event) must be treated separately. The Secretary may issue a summons for one taxable year even if a Justice Department referral is in effect with respect to the taxpayer for another taxable year.

The restrictions on the use of administrative summonses stated in *La Salle* arise from the provision of present law which limits the use of administrative summons to the determination and collection of taxes. The bill expands this authority to include the right to issue a summons for the purpose of inquiring into any offense connected with the administration or enforcement of the Internal Revenue laws.

The bill does not in any way alter the other requirements under present law that the Secretary make the showings required under *U.S.* v. *Powell.* Further, the provision is in no way intended to broaden the Justice Department's right of criminal discovery or to infringe on the role of the grand jury as a principal tool of criminal prosecution.

The committee expects that the Justice Department will continue to have primary responsibility for criminal prosecutions under the tax laws and that the Internal Revenue Service will not use its summons authority to pursue a civil or criminal investigation after the case subject to investigation is referred to the Department of Justice for any of the purposes described above, or a request for the return of, or return information with respect to, any taxpayer under investigation is made by the Attorney General, Deputy Attorney General, or Assistant Attorney General, as described above.

Effective Date

This provision is effective the day after the date of enactment.

7. Withholding on Pensions, Annuities, and Certain Other Deferred Income

a. Withholding on pensions, annuities, and certain other deferred income (sec. 361 of the bill and secs. 3402, 3405, 6047 and 6704 of the Code)

Present Law

Under present law, income tax generally is not required to be withheld from benefits paid under a tax-qualified pension, profit-sharing, or stock bonus plan, under a tax-sheltered annuity program or under an IRA (an individual retirement account or annuity or a U.S. retirement bond). Also, payments under a commercial annuity contract generally are not subject to withholding. However, tax is required to be withheld on an annuity payment if a voluntary withholding request by the recipient is in effect.

Reasons for Change

The committee believes that a more effective withholding system which applies both to annuities and other types of distributions from pension, etc., plans will assist taxpayers in better understanding and complying with the tax laws in regard to pension payments and will relieve these taxpayers of estimated tax burdens and penalties. In particular, the committee believes that a wage-based voluntary withholding system will reduce recordkeeping and estimated tax burdens on the elderly.

In addition, the committee believes that it is important for participants and the Internal Revenue Service to have the information necessary to determine the proper tax treatment of pension distributions. It is more efficient to require such information to be provided by the relatively more sophisticated and automated payors of pensions than the individuals who receive pensions. Further, to insure that payors can provide accurate information to participants and the Internal Revenue Service, the committee believes that it is necessary to insure that payors maintain adequate records.

Explanation of Provision

Withholding required

Under the bill, tax will generally be withheld from all designated distributions (the taxable part of payments made from or under a pension, profit-sharing, stock bonus, or annuity plan, a deferred compensation plan where the payments are not otherwise considered wages, an IRA, or a commercial annuity contract). A partial surrender of an annuity contract will also be considered a distribution subject to withholding. The withholding rate is determined by the nature of the distribution. Tax will be withheld on periodic payments (typically, annuity payments) as if those payments were wages paid by an employer to an employee for the appropriate payroll period (subject to the usual rules for personal and other exemptions from withholding). It is anticipated that the Secretary of the Treasury will provide guidance to determine the appropriate payroll period.

For nonperiodic distributions, tax generally will be withheld at a 10 percent rate. In the case of qualified total distributions (generally, a distribution made within one taxable year of the recipient, which consists of the balance to the credit of the participant under the plan) under qualified pension, etc., plans (sec. 401(a) or 403(a)), tax will be withheld under special rules designed to reflect the 10-year forward income averaging and capital gains treatment provided for lump sum distributions. In the case of qualified total distributions under a qualified pension, etc., plan which are made on account of a participant's death, these special rules will take into account the exclusion provided for employer-provided death benefits (whether or not actually allowable to the payee).

Amount withheld

For periodic payments subject to withholding, tax will generally be withheld pursuant to the recipient's withholding certificate. In the case of any payment for which a withholding certificate is not in effect, the amount withheld will be determined by treating the payee as a married individual claiming two withholding exemptions. Thus, in effect, there will be no withholding on a floor amount equal to the first $5,400 (in 1983) of periodic payments. However, to prevent possible under-withholding where a recipient has other income and to insure that recipients are aware that periodic payments are taxable, a payor will still be required to notify every annuity recipient of the withholding rules. No similar "floor" is provided for nonperiodic payments.

With respect to any designated distribution, the maximum amount withheld shall not exceed the sum of the amount of money and the fair market value of other property (other than employer securities (within the meaning of sec. 402(a)(3)) received in the distribution. Thus, no payor will be required to liquidate employer securities qualifying for special deferral of net unrealized appreciation merely to satisfy the withholding rules.

Elections

Under the bill, recipients may elect not to have the withholding rules apply. For periodic payments, an election can be made for any reason and will be effective for the calendar year for which it is made, unless revoked before the end of the calendar year. For nonperiodic distributions which are not qualified total distributions, a recipient may elect, for any reason, not to have the withholding rules apply. An election with respect to a nonperiodic distribution generally will be effective only for the distribution for which it is made. However, to the extent provided in regulations to be issued by the Secretary of the Treasury, an election may apply to subsequent nonperiodic distributions made by the payor to the payee under the same arrangement and within the same calendar year.

In the case of qualified total distributions, a participant may elect not to have the withholding rules apply with respect to any portion of the distribution only if the recipient provides notice that such portion will be rolled over, tax-free, to another qualified plan or tax-sheltered annuity contract, or to an IRA.

Notice

Payors will be required to notify recipients of their right to elect not to have the withholding rules apply. The form and content of the notice will be determined by the Secretary of the Treasury.

For periodic payments, the notice will be required not earlier than 6 months before the date on which the payor anticipates that the first payment will be made, and not later than 2 months prior to such date. For purposes of the withholding rules relating to periodic payments, if the payments are suspended (for example, by reason of a retiree's return to the service of the employer), the first periodic payment made after the suspension will be treated as a first periodic payment. In addition, the bill requires that payors of periodic payments notify payees at least once each year of the right to make, renew, or revoke the withholding election. This annual notice must be provided no earlier than July 1 and no later than October 1.

With respect to a nonperiodic distribution, the bill requires the payor to provide notice of the right to elect not to have income tax withheld at the time of the distribution. The bill also permits Treasury regulations to require earlier notice by the payor in certain cases. For example, unless recipients of lump sum distributions are notified of their rights to elect not to have withholding apply before they receive their distributions, they may be unable to transfer the full amount eligible for a tax-free rollover. In order to prevent this result it is anticipated that Treasury regulations will require that recipients of total distributions from qualified plans be informed before plan distributions are made of their right not to have withholding apply. In order to provide participants with a reasonable time in which to make this election, it is anticipated that this notice will generally be required to be provided no more than 90 days and no less than 30 days before the time of the distribution.

Coordination with other provisions

The bill's rules for designated distributions will not apply to amounts paid as wages subject to the usual wage-withholding rules. In addition, the rules of present law for income tax withheld from wages will apply to amounts withheld from designated distributions. With respect to designated distributions, the bill replaces the provisions of present law which permit voluntary withholding on amounts paid as an annuity.

Reports

To improve compliance, the bill provides for reporting of necessary information by employers, plan administrators, and issuers of insurance or annuity contracts. The form and manner of reporting will be determined under forms or regulations prescribed by the Secretary of the Treasury. It is expected that these reports will include information sufficient to identify the total amount of the distribution, the amount of accumulated deductible employee contributions, the amount of nondeductible employee contributions, the amount of capital gain, the amount of ordinary income, the cost basis of any employer securities included in a distribution, and possibly, in the case of qualified total distributions, information regarding the 5-year rule and separation from service rule, and such other information as the Secretary shall by forms or regulations require.

The bill also provides a new penalty where the data base needed for reports is not maintained. The penalty applies whether or not reports are due for the period during which the recordkeeping failure occurs. No penalty will be imposed for a failure to meet the recordkeeping rules when the failure is due to reasonable cause and not willful neglect. Also, no penalty will be imposed on a person for a recordkeeping failure that is due to a prior failure with respect to which the penalty has already been imposed on that person or for a recordkeeping failure which occurs before 1983, if all reasonable efforts have been made to correct the prior failure.

With respect to post-enactment data, it is expected that these recordkeeping requirements will be strictly enforced. However, to the extent that a person is required to determine required information applicable to pre-1983 service, a person shall be treated as having made all reasonable efforts to correct a pre-1983 recordkeeping failure if such person uses whatever records may be reasonably accessible and makes whatever calculations are necessary to determine the required information. For example, if a plan or employer maintaining the plan has, or has access to, only the plan documents and the records of employee compensation for the pre-1983 period, it may derive employer and mandatory employee contributions based on that data.

If the employer or the employee has payroll data indicating amounts of contributions made through payroll withholding, those records may be used to derive voluntary employee contributions, mandatory contributions and, if applicable, matching employer contributions.

If accessible records are insufficient to make an approximation of the required information, the person may make a reasonable estimate. For example, if records are available with respect to a representative number of employees, the person may estimate information for other similarly situated employees based on those records.

Effective Dates

In general, the withholding rules apply to designated distributions made after December 31, 1982. For purposes of applying the rules to periodic payments which commence prior to January 1, 1983, the first periodic payment after December 31, 1982, is considered the first periodic payment made. Thus, withholding will be required with respect to any periodic payment made after December 31, 1982, and the payor must notify the recipient of his right to elect not to have withholding apply no later than two months prior to the date of such payment. The reporting requirements and voluntary withholding rules will be effective on January 1, 1983, and the recordkeeping penalties will be effective on January 1, 1985.

b. Partial rollovers of IRA distributions (sec. 362 of the bill and sec. 408 of the Code)

Present Law

Amounts received from an individual retirement account or annuity (IRA) generally are taxed in full as ordinary income, because neither the contributions nor the earnings thereon have been subject to tax previously (sec. 408(d)). However, present law provides an exception for certain distributions which are rolled over to another eligible retirement plan. There is no requirement that the entire balance in the IRA be distributed, but the distribution qualifies for tax-free rollover treatment only if the entire amount received in the distribution is, in fact, rolled over to another eligible retirement plan within 60 days of the date of the distribution.

Under present law, a lump-sum distribution from a qualified pension, etc., plan or a complete distribution upon termination of such a plan is not includible in a participant's gross income to the extent that the participant makes a rollover contribution to an IRA or to another qualified plan within 60 days of the date of the distribution (sec. 402(a)). If the participant makes a rollover contribution of less than the full amount eligible for rollover treatment, the amount retained is taxed in the year of receipt as ordinary income and is not eligible for special 10-year income averaging.

Thus, while a participant may take a partial distribution from an IRA and qualify for tax-free rollover treatment only if the entire distribution is rolled over, a participant in a qualified plan who receives a total distribution may qualify for tax-free rollover treatment to the extent of any partial rollover.

Reasons for Change

Because present law does not permit partial rollovers from IRAs, imposition of withholding taxes on IRA distributions may cause the entire distribution to be taxed to the recipient, whether or not any amount is, in fact, rolled over to another eligible retirement plan. The committee believes it is appropriate to permit partial rollovers from IRAs to prevent this result.

Explanation of Provision

Under the bill, a distribution from an IRA is not includable in the recipient's gross income to the extent that the participant makes a rollover contribution to another eligible retirement plan within 60 days of the receipt of the distribution.

If the recipient makes a rollover contribution of less than the full amount of the distribution, the amount retained will be taxed in the year of receipt as ordinary income.

Effective Date

The bill applies to distributions made after December 31, 1982.

8. Withholding on dispositions by foreigners of United States real property interests (sec. 371 of the bill and sec. 6039C and new sec. 1444 of the Code)

Present Law

In 1980, the Congress adopted the Foreign Investment in Real Property Tax Act, requiring that foreign persons who dispose of U.S. real property interests pay tax on any gain realized on the disposition. The interests on whose disposition recognition occurs include real estate and shares in certain U.S. corporations owning primarily real estate. The intent of the legislation was to treat foreign investors the same as U.S. persons by removing certain preferential tax treatment previously accorded them.

The Act provides for enforcement of the tax on foreigners through a system of information reporting designed to identify foreign owners (rather than sellers) of U.S. real property interests.

Reasons for Change

A major problem with the Foreign Investment in Real Property Tax Act is that it can often be easily evaded. Since the tax is not due until a tax return is filed after the end of the year, a foreign person can sell his U.S. real estate, take the proceeds out of the United States and, since he is beyond the jurisdiction of the United States, not pay any tax to the United States on the sale. Moreover, through nominees and foreign corporations established in tax havens, he can reinvest these untaxed proceeds back in the United States with impunity.

The Senate version of the 1980 legislation sought to deal with this problem by requiring that the purchaser of the U.S. real estate or other persons with control over the amount paid withhold the tax that would be due on the sale. This is the method used to insure collection of tax on other payments of income to foreign persons, and in fact is used by almost all countries.

The conference dropped the withholding provision. The conferees were concerned about protecting withholding agents who might not know that a seller is a foreign person. The conferees agreed that it would be necessary to structure withholding provisions carefully to insure that they would not inadvertently disrupt the U.S. real estate market or expose U.S. buyers or U.S. agents of foreign sellers of U.S. real estate to liability where such liability is not appropriate. In 1981, the Senate again voted to impose withholding on sales of U.S. real property to foreigners, but a conference committee failed to agree to withholding.

In lieu of withholding, the provisions of the real estate bill are currently to be enforced through information reporting. Enforcement through withholding has several advantages over enforcement through information reporting. Most importantly, withholding should prove more effective than information reporting, and will eliminate the problem of identifying owners of bearer shares. It will also relieve U.S. persons of significant paperwork because the bill authorizes the Treasury to relax or eliminate the information reporting requirements. In addition, the relaxation or elimination of information reporting could reassure legitimate foreign investors who may fear disclosure of their holdings to their potential political adversaries in their home countries.

Explanation of Provision

The bill requires withholding by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (hereinafter collectively referred to as "withholding agent") where U.S. real estate is acquired from a foreign person.

Withholding rate

The amount to be withheld is the smallest of: first, in the case of a corporate transferor, 28 percent of the sales price, or in the case of a noncorporate transferor, 20 percent of the sales price; second, the transferor's maximum tax liability, discussed below; or third, the fair market value of that portion of the sale proceeds which is within the withholding agent's control. In determining the amount within the withholding agent's control, the withholding agent may be deemed to control certain debts within two years of the transfer for which the transferee or the property is liable. This last rule, designed to prevent mortgaging out of gain, is to be subject to such exceptions as the Secretary may provide by regulations.

The transferor's maximum tax liability consists of two elements: first, the maximum amount that the Treasury (upon request of the transferor or the withholding agent) determines that the transferor could owe on his gain on the sale, discussed below, and second, any unsatisfied prior withholding tax liabilities caused by prior foreign ownership with respect to the transferred property that, under the bill, were previously required to be withheld but were not withheld. The first element, the maximum tax that the transferor could owe on the sale, is to be calculated on a transaction by transaction basis at the highest possible tax rate for that transaction. For example, if a nonresident alien purchased unimproved land on June 1, 1982 for $100,000, and sold the land on September 1, 1983, for $110,000, his maximum tax liability for that sale would be $2,000, i.e., 20 percent, the highest marginal tax rate for long-term capital gains of an individual, times $10,000, his net gain. Neither offsetting transactions (completed or anticipated) nor the presumed absence of other income during the taxable year would enter into the calculation of the maximum tax that the transferor could owe on the sale.

Withholding agent

While the bill generally places an obligation to withhold when U.S. real estate is acquired from a foreign person, the withholding requirement applies to a transferee, a transferees agent, or a settlement officer only if he knows or has received notice from either the transferor or any agent of the transferor that the transferor is a foreign person. The transferor is required to notify the transferee, the transferee's agent, and the settlement officer that the transferor is a foreign person. A transferor's agent is also required to notify the transferee that the transferor may be a foreign person if the agent has reason to believe that the transferor may be a foreign person. If the transferor's agent fails to make a reasonable inquiry about the transferor's status, he is required to notify the transferee that the transferor may be foreign. However, the transferor's agent is relieved of any responsibility to give notice to a transferee if he relies in good faith on a written statement of the transferor—or, in the case of a transferor's agent retained by another agent of the transferor a written statement by that other transferor's agent—that the transferor is a U.S. person. A transferor's agent who does not carry out his obligation to provide notice is required to withhold the appropriate amount from any of the transferee's consideration he has within his control, including any compensation received by him in connection with the transaction.

The bill defines transferor's agent as a person who actually represents a foreign transferor in negotiations preceding the transaction or at settlement of the transaction. The definition also includes a person who, in negotiations or at settlement, represents the transferor indirectly through a subagency relationship. A person who, at the transferor's request, procures the services of an agent for negotiations or settlement, is also an agent of the transferor. The bill specifies certain actions that a person might take, even on behalf of the transferor, without automatically coming within the definition of an agent of the transferor. Receipt or disbursement of any of the consideration for the transaction (for instance, by an escrow agent) does not automatically cause agency status; neither does recording of documents involved in the transaction.

Exemptions from withholding

The bill provides for exemptions from withholding in three cases. First, withholding is not required if the transferee is to use the real property as his principal residence and the purchase price is $200,000 or less. Second, withholding is not required if the transferor obtains a qualifying statement from the Treasury that he is exempt from tax or has provided adequate security for payment of the tax, or has otherwise made arrangements with Treasury for the payment of the tax. Third, withholding is not required if the property being transferred is stock of a corporation and the transfer takes place on an established U.S. securities market.

Miscellaneous

Provision is made for the Treasury, upon request of the transferor or any withholding agent, to reduce the amount of withholding otherwise required. Any such request, as well as a request for a qualifying statement, must be acted upon within 30 days of receipt of the request.

The bill provides special rules for withholding by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate. These persons are required to withhold from amounts which such entities have in their custody and which are attributable to the disposition of a U.S. real property interest, but only if the amounts are income of a nonresident alien individual or foreign corporation, partnership, trust, or estate.

Withholding is also required where a U.S. real property interest in distributed by a foreign corporation or is disposed of in certain transactions on which gain is recognized under the U.S. real property rules but that, under the Code's general rules, would be nonrecognition transactions. For example, when a liquidating foreign corporation distributes a U.S. real property interest to its shareholders, it is required to withhold a tax equal to 28 percent of the fair market value of the property reduced by the adjusted basis of the property.

Effective Date

The withholding requirements of this provision apply to payments of consideration with respect to the acquisition of a United States real property interest that are made on or after January 1, 1983.

9. Transactions Outside the United States

a. Court jurisdiction and enforcement of summonses in the case of persons residing outside the United States (sec. 372 of the bill and sec. 7701(a) of the Code)

Present Law

Under present law, an administrative summons may be directed to a U.S. person outside the United States. However, it may not be enforceable because section 7604 and other operative sections of the Code specifically confer jurisdiction to enforce the summons on a District Court only when a person "resides or is found" in a judicial district of the United States. Because a U.S. citizen or resident living abroad may not reside in or be found in a judicial district of the United States there may be no district court that can enforce a summons served on such a person.

Under current law, proper service of summons is accomplished only when an attested copy is delivered in hand to the person to whom it is directed, or left at his usual place of abode (sec. 7603).

Reason for Change

The committee believes that the Federal courts should be able to enforce a properly served administrative summons on a U.S. citizen or resident abroad.

Explanation of Provision

The committee bill establishes jurisdiction for summons enforcement actions involving U.S. citizens or residents living abroad in the United States District Court for the District of Columbia. This is accomplished by treating a citizen or resident of the United States who does not reside in any U.S. judicial district, and who is not found in any U.S. judicial district, as residing in the District of Columbia for tax purposes relating to jurisdiction of courts and enforcement of summons.

The bill does not affect the current law requirements for proper service of a summons. Accordingly, the provisions of present law that require delivery by hand or leaving of the summons at the usual place of abode will have to be complied with (sec. 7603).

Effective Date

The provision will be effective on the day after the date of enactment.

b. Penalty for failure to furnish information with respect to foreign corporations (sec. 373 of the bill and sec. 6038 of the Code)

Present Law

A U.S. person who controls a foreign corporation is required to furnish the Internal Revenue Service with certain information concerning the corporation (section 6038(a)). The Secretary is authorized to prescribe regulations setting forth the specific information to be furnished. The penalty for failure to furnish any required information is a 10-percent reduction of the U.S. person's creditable foreign taxes. Additional five percent reductions are provided if the failure to furnish information continues 90 days or more after notice to the U.S. person required to provide the information. In such a case, creditable foreign taxes may be reduced by 5 percent for each 3-month period or fraction thereof during which the failure continues. In no event, however, can the penalty for a failure to furnish information exceed the greater of $10,000 or the foreign corporation's income for the tax year with respect to which the failure occurs. The penalty is not available if it is shown to the satisfaction of the Secretary that reasonable cause exists for failure to furnish the required information on time.

Reasons for Change

Despite complaints about inadequate reporting with respect to controlled foreign corporations, penalties generally are not imposed (sec. 6038(b)). In part, this is because the penalty is complicated. It also may be unduly harsh in some cases, because a taxpayer could incur a substantial penalty for a minor failure. On the other hand, a sanction reducing creditable foreign taxes is of no use if the U.S. person required to report paid no foreign income taxes during the year in question.

Explanation of Provision

The committee bill adds a fixed-dollar penalty for failure to furnish the Internal Revenue Service the information required by present section 6038 of the Code. The penalty is $1,000 for each failure to furnish information for an annual accounting period (generally a taxable year) of the foreign corporation. If the failure continues for more than 90 days after notification by the Secretary, then there are additional $1,000 penalties for each 30-day period (or fraction thereof) during which the taxpayer continues to fail to produce the requested information. In no event, however, can failure to furnish information for any one annual accounting period of any one foreign corporation cause accumulated $1,000 penalties to exceed $25,000. As under present law, so long as it is shown to the satisfaction of the Secretary that reasonable cause for the failure exists, no penalty is due.

The bill retains the potentially significant penalty of a reduction in foreign tax credit to be imposed where the Internal Revenue Service considers it appropriate. Where both penalties are applied, the amount of the reduction in the foreign tax credit is reduced by the amount of the fixed-dollar penalty imposed. It is intended that the reduction in foreign tax credit penalty may be waived in some cases where the flat $1,000 penalty will be imposed.

The committee intends that there be no change in the present law substantive reporting requirements.

Effective Date

The provision is effective for annual accounting periods ending after the date of enactment.

c. Returns with respect to foreign personal holding companies (sec. 374 of the bill and secs. 6035 and 6679 of the Code)

Present Law

Each person who is an officer or director of a foreign personal holding company, and each 50-percent or greater U.S. shareholder of a foreign personal holding company, is required to file certain reports with respect to that corporation (section 6035). Both monthly reports of stockholdings and annual reports of income are required. The monthly report of stock holdings in the corporation is due on the 15th day of each month for which a report is required, but the Secretary is authorized to delay the filing of this report to a due date that is the 15th day of a later month. By regulations the Secretary has delayed the filing date until after the close of the foreign corporation's taxable year. The report of the income of the foreign corporation must be filed within 60 days after the close of the taxable year of the foreign personal holding company to which it relates.

Present law provides only a criminal penalty for violation of these reporting requirements.

Reasons for Change

The Internal Revenue Service requires persons engaging in international transactions, and persons who transfer assets to foreign entities, to file a number of different forms. Often, a person may have to file more than one form covering the same foreign entity for the year. The Internal Revenue Service would like to combine a number of forms related to international transactions into one and generally require that it be filed after the close of the filer's taxable year. However, the filing dates tied to the date of a transaction for certain reports, as well as the filing dates for reporting relating to foreign personal holding companies, make it impossible for these forms to be combined.

The Internal Revenue Service is concerned that current application of reporting requirements to shareholders only when they own (directly or through attribution) 50 percent or more of the corporation creates an unintended loophole in the reporting requirements. Foreign personal holding company income is subject to U.S. tax when five or fewer U.S. individuals own more than half the corporation's stock (sec. 552(a)(2)). Shareholder reporting requirements should conform more closely to underlying tax liability. The reporting required of U.S. officers and directors (as opposed to shareholders) does not cure this problem, because controlling U.S. shareholders can arrange for foreigners to serve as officers and directors.

Current law omits a civil penalty for violation of these requirements. In some respects, too, the reporting requirements of current law are inadequate (as to ownership of options and as to the nature of classes of stock). Morever, current law omits a reporting requirement when the circumstances triggering the filing requirement no longer exist by the filing date.

Explanation of Provision

The bill replaces the current foreign personal holding company reporting requirements. The bill imposes its reporting requirements on 10-percent (rather than 50-percent) shareholders of a foreign personal holding company as well as on officers and directors. The calculation of whether a person is a 10-percent shareholder involves indirect ownership as well as direct ownership.

The required information includes both shareholder information and income information as well as such other necessary information as the Secretary shall prescribe. Required shareholder information includes the names and addresses of all persons who held shares, options, and convertible securities during the taxable year; a description of each class of shares and the total number of shares of each class outstanding at year's end; the number of shares of each class, options, or convertible securities held by each person; and any changes in the holdings of shares, options, or convertible securities during the year. Required income information includes the foreign personal holding company's gross income, credits, taxable income, and undistributed foreign personal holding company income for the year.

The bill changes present law to give the Internal Revenue Service more flexibility in establishing filing dates for reports relating to foreign personal holding companies and to make it possible for the Internal Revenue Service to include the foreign personal holding company reports in a combined international report. In particular, it authorizes the Commissioner to designate the time when the foreign personal holding company reports and returns must be filed.

Whether a person is required to file a return is determined on the date the return is due. If, on that date, no person is required to file (because, for example, the corporation has been dissolved), then filing is required of the persons who were officers, directors or 10-percent shareholders on the last day of the corporation's taxable year for which there was a person required to file.

If two or more persons are required to file, the bill provides that the Secretary may, by regulations, require only one of them to file.

The bill also adds a $1,000 civil penalty for failure to file a proper foreign personal holding company information return. This penalty does not apply, however, if the failure is shown to be due to reasonable cause.

Effective Date

This provision applies to failures to furnish information that was due on the day after the date of enactment and thereafter.

d. Delay in date for filing certain returns relating to foreign corporations and foreign trusts (sec. 375 of the bill and secs. 6046 and 6048 of the Code)

Present Law

Under present law, a return must be filed by U.S. persons who become officers or directors of a foreign corporation and by U.S. persons who acquire at least a 5-percent interest (or an additional 5-percent interest) in a foreign corporation (sec. 6046). The return must be filed within 90 days of the event that triggers the duty to file.

A return must also be filed by certain U.S. persons transferring property to a foreign trust (sec. 6048). The return must be filed within 90 days of the triggering event, in this case creation of the trust or a transfer to the trust.

Reasons for Change

As described under the explanation of the foreign personal holding company reporting requirements (section 374 of the bill), the Internal Revenue Service is considering consolidating a number of international reporting forms. The specific reporting dates tied to a triggering event, rather than a taxable year, make it impossible to include these reports relating to foreign corporations and trusts in the combined report.

Explanation of Provision

The committee bill authorizes the Secretary to delay the reporting of transactions covered by section 6046 (foreign corporations) and section 6048 (foreign trusts) until some date after the 90th day after the transaction that must be reported.

Effective Date

The provision applies to returns due after the date of enactment.

e. Technical amendment relating to penalty under section 905(c) (sec. 376 of the bill and sec. 905 of the Code)

Present Law

If a foreign tax for which a U.S. foreign tax credit was taken is refunded the taxpayer must notify the Secretary of the refund (section 905(c)). The Secretary then redetermines the taxpayer's tax and notifies the taxpayer of the amount due. Interest on any additional tax does not begin to run until the taxpayer receives the refund of the foreign tax. This rule is in contrast to the general rule for payment of interest which is that interest is imposed on any amount of tax that is due but not paid on the last date prescribed for payment (section 6601).

Section 2(c)(1) of Public Law 96-603 added a sentence to section 905(c) that appears to provide that if a taxpayer does not notify the Commissioner of an adjustment in foreign taxes then interest on an underpayment of tax caused by an adjustment of the taxpayer's foreign taxes paid will begin to run from some point in time before the taxpayer received the refund of the foreign tax. This provision was intended to penalize a taxpayer for failing to notify the Commissioner of a refund of foreign taxes.

Reasons for Change

The last sentence of section 905(c) is ambiguous. It is also unnecessary because the same Act that added it also added a penalty to the Code (section 6689) for failure to report a redetermination of foreign tax.

Explanation of Proposal

The committee bill would repeal the last sentence of section 905(c).

Effective Date

This provision is effective for all years.

10. Modification of Interest Provisions

a. Daily compounding of interest (sec. 381 of the bill and new sec. 6622 of the Code)

Present Law

Under present law, interest payable to or by the United States under the internal revenue laws is not compounded. Thus, annual interest is payable only on the principal amount of an obligation (for example, an underpayment) and not on any accrued interest component thereof.

Reasons for Change

Failure to compound interest owing under the Code significantly reduces the effective rate of interest provided for under the internal revenue laws. As a result, neither the United States nor taxpayers are adequately compensated for the value of money owing to them under the tax laws. This undercompensation is magnified the longer the debt is outstanding. For example, at a 15-percent interest rate the satisfaction of a $100 obligation after 5 years will require $211.67 if interest is compounded daily but only $175 if interest is not compounded. In addition, the cost of allowing the obligation to remain unpaid a sixth year would be $15 under a simple interest system and $34.24 if interest is compounded daily. The committee believes that the understatement of economic interest may induce some taxpayers to delay resolution of tax controversies, thus putting an unreasonable burden on the Internal Revenue Service.

Explanation of Provision

Under the Committee bill, all interest payable under the internal revenue laws will be compounded daily. This adjustment will conform computation of interest under the internal revenue laws to commercial practice. The change will also offset any other amounts computed by reference to the interest rate provided for in the code. It is anticipated that the Secretary will prescribe tables or formulas which will permit taxpayers to compute this compound interest themselves. Because taxpayers will be required generally to rely on interest tables if any form of interest compounding is adopted, the committee adopted a rule of daily compounding because that rule appears simplest to administer.

Effective Date

This compounding requirement will apply to interest accruing after December 31, 1982.

b. Semi-annual determination of rate of interest (sec. 382 of the bill and sec. 6621 of the Code).

Present Law

Under present law, the rate of interest paid on underpayments, overpayments, and for certain other purposes under the internal revenue laws, must be established by the Treasury no later than October 15 of any year. The interest rate is based on the average predominant prime rate (the rate quoted by commercial banks to their preferred customers for short-term loans) during September of that year rounded to the nearest full percentage point. The new rate is effective January 1 of the following year. Thus, the rate of interest is determined once a year based on September's average predominant prime rate.

Reasons for Change

The committee believes that because of dramatic monthly fluctuations in interest rates between months, a longer base period for establishing the rate and more frequent adjustments are needed to accurately reflect the cost of borrowing money during the year and to prevent a wide divergence between the statutory rate and the actual market rate of interest. Thus the statutory interest rate substantially overstated the real economic interest rate. The committee continues to believe that the prime rate is the most accurate measure of the true economic interest rate.

Explanation of Provision

Under the bill, interest rates would be redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year).

Effective Date

The amendment is effective for adjustments taking effect after December 31, 1982. Thus, the first adjustment will be based on the adjusted prime rate for April through September 1982 and will take effect in January 1, 1983.

c. Restrictions on payment of interest for certain periods (sec. 383 of the bill and secs. 6601 and 6611 of the Code)

Present Law

In general, under present law, interest on refunds, credits and offsets runs from the date of overpayment, which is usually the date prescribed for filing the particular return, to a date (in the case of a refund) preceding the date of the refund check by not more than 30 days, or (in the case of a credit) to the due date of the amount against which the credit is taken. Further, under present law, if an overpayment of income tax for individuals is refunded within 45 days after the last date prescribed for filing the return, or, if later, within 45 days after the date the return is filed, no interest is payable on the overpayment. An overpayment resulting from a net operating loss carryback, net capital loss carryback, or credit carryback is treated as having occurred at the close of the year in which the carryback arose. In the case of any overpayment of tax resulting from the carryback of taxes paid or accrued to a foreign country or U.S. possession, such overpayment is deemed not to have been paid or accrued prior to the close of the taxable year of the taxpayer in which such amounts were actually paid or accrued.

In the case of an underpayment of tax, interest runs from the last date prescribed for payment of the tax (usually the return due date) without regard to extensions, to the date the tax is paid. If the last date for payment is not otherwise prescribed, it is deemed to be the date liability for the tax arises (but in no case later than the date the Secretary makes notice and demand for the tax). If there is an underpayment of tax for any taxable year, and the amount of the underpayment is reduced by reason of the carryback of a net operating loss, net capital loss, or because of the increase in any credit for the taxable year because of a credit carryback from another taxable year, such reduction is not effective for any period prior to the last day of the taxable year in which the net operating loss, the net capital loss, or credit carryback arises.

Reasons for Change

The committee believes that it is inappropriate to require that the United States pay interest on amounts prior to the time it has notice that it owes such an amount. Thus, no interest is payable with respect to any overpayment until the Secretary can determine that such an overpayment exists (or, in the case of an underpayment, that the underpayment is reduced) by way of a notice of such overpayment (or reduced underpayment) being filed in processable form. The committee does not believe it necessary to apply such rules retroactively to taxpayers who may not have been in a position to file early refund claims.

Explanation of Provision

Under the committee bill, the general rule with respect to the payment of interest on overpayments is unchanged when the credit or refund is claimed in a timely filed return. However, when the return is late because it is filed after the due date (determined with regard to extensions) no interest is payable on the overpayment for any period prior to the date on which the return is filed. For this purpose, and for purposes of determining whether a refund has been made within 45 days after the return is filed, no return is treated as filed until filed in processible form. The return is in "processible form" if it is on a permitted form; contains sufficient taxpayer identifying information and signatures; and sufficient information to permit the Secretary to verify mathematically the amount of tax liability shown on the return.

Further, under the committee bill, an overpayment due to a net operating loss or a net capital loss carryback, or a credit carryback is deemed not to arise before the application for tentative carryback adjustment is made, or the claim for credit or refund is filed with respect to such overpayment. Thus, interest is not payable on such carrybacks for any period prior to the time such application or claim is filed in processible form.

Similarly, if there is an underpayment of tax for any taxable year and the amount of the underpayment is reduced by reason of the carryback of a net operating loss or a net capital loss, or because of an increase in any credit for the taxable year because of a credit carryback from another taxable year, such reduction will not affect the computation of interest for any period prior to the date the application for tentative refund adjustment is made or the claim for credit or refund, as the case may be, is filed.

operating loss or a net capital loss carryback, or a credit carryback, is

The committee limited the denial of interest to such carryback claims because of the availability of an expedited refund procedure for such amounts.

Effective Date

The provisions with respect to late returns and returns in processible form are effective after the 30th day after the date of enactment of the Act. The provision with respect to payments of interest on claims for loss carrybacks, etc., applies to payments of interest made after 30 days after the date of enactment with respect to interest accruing after the date of enactment.

11. Miscellaneous Provisions

a. Disallowing deductions for drug dealing (sec. 391 of the bill and sec. 280E of the Code)

Present Law

Ordinary and necessary trade or business expenses are generally deductible in computing taxable income. A recent U.S. Tax Court case allowed deductions for telephone, auto, and rental expenses incurred in the illegal drug trade. In that case, the Internal Revenue Service challenged the amount of the taxpayer's deduction for cost of goods (illegal drugs) sold, but did not challenge the principle that such amounts were deductible.

On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments.

Reasons for Change

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.

Explanation of Provision

All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.

Effective Date

The provision would apply to amounts paid or incurred after the date of enactment in taxable years after that date.

b. Report on forms (sec. 393 of the bill)

This provision of the bill requires the Secretary to study and report to the Congress, no later than June 30, 1983, on methods of modifying the design of the forms used by the Internal Revenue Service to achieve greater accuracy in the reporting of income and the matching of information reports and returns with the actual income tax returns.

12. Internal Revenue Service staff increases (sec. 392 of the bill)

Present Law

Public Law 97–92 (the third continuing resolution) enables the Internal Revenue Service to maintain an average of 85,363 positions during fiscal year 1982. Of this total number of positions, 14,556 are in the investigation and collection functions, 27,882 are in the examination functions, and 1,833 are in the appeals functions. The following table sets forth average employee levels in these three functions and in the entire IRS for fiscal year 1982 and the preceding three years:

	Number of positions			
	1979	1980	1981	1982
Function:				
Investigation and collection	11,753	12,802	13,185	14,556
Examination of deficient returns	27,747	28,370	27,402	27,882
Appeals	1,628	1,884	1,858	1,833
Total IRS employment	86,168	87,464	86,156	85,363

The Administration's budget request for fiscal year 1983 includes a net increase in Internal Revenue Service manpower of 3,310 average positions. Included in this request is a 5,225 increase in the number of employees committed to collection of delinquent taxes, determination of amounts of underreported income, and identification of improper deductions on tax returns. The additional employees are to be distributed within the Internal Revenue Service in the following way:

Function:	New positions
Collection of delinquent accounts	3,000
Identification of nonfilers	1,000
Examination of deficient returns	1,000
Appeals	225
Total	5,225

Reasons for Change

The committee believes that adequate staffing for the Internal Revenue Service is essential to achieve better compliance with the internal revenue laws.

Explanation of Provision

The bill contains a sense of the Congress resolution that additional funds be appropriated to the Internal Revenue Service to provide additional staff over that requested by the Administration sufficient to collect additional tax revenues of at least $1 billion in fiscal year 1984 and $2 billion in fiscal year 1985.

13. Revenue Effect of Compliance Provisions

Withholding on dividends and interest

The proposals of the provisions for withholding on interest, dividends, and patronage dividends will increase fiscal year budget receipts by $4,333 in 1983, $3,626 in 1984, $4,066 in 1985, $4,710 in 1986, and $5,294 in 1987.

*Other compliance provisions**

The other compliance provisions in the bill (items 2 through 11, above) will increase fiscal year budget receipts by $2,365 in 1983, $3,430 in 1984, $4,580 in 1985, $5,405 in 1986, and $5,818 in 1987.

Internal Revenue Service funding

The additional funding for the Internal Revenue Service proposed by the Administration would increase fiscal year budget receipts by $2,100 in fiscal year 1983, $2,400 in 1984, $2,400 in 1985, $1,300 million in 1986, and $600 million in 1987.

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*This estimate does not take into account the revenue effect associated with the provisions applicable to direct sales and compensation for services performed by nonemployees. That estimate is included in section F-1 of this report.

D. Pension Provisions

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (sec. 401(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are accorded special long-term capital gain and 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account (IRA) or another qualified plan, and (4) certain estate and gift tax exclusions are provided.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted. Amounts distributed or made available under tax-sheltered annuities or custodial accounts generally are includible in gross income. However, certain lump sum distributions may be rolled over, tax-free, to another such annuity contract or account or to an IRA. In addition, certain estate tax and gift tax exclusions apply.

If an individual retirement account or individual retirement annuity (IRA) qualifies as a simplified employee pension (SEP), the annual IRA deduction (generally the lesser of $2,000 or 100 percent of compensation) is increased by the lesser of $15,000 or 15 percent of compensation. The increase in the deduction limit applies only to employer contributions (sec. 408(k)). Except in the case of certain correcting distributions, all distributions from SEPs are includible in gross income unless rolled over to another IRA. Amounts held in a SEP can qualify for exclusions under the estate tax and gift tax rules for IRAs.

1. Limits on contributions and benefits (secs. 246 and 247 of the bill and secs. 219, 401, 404, 408, 415, and 1379 of the Code)

Present Law

Overall limits

In order to limit the extent to which individuals can use tax-favored arrangements to provide for retirement, the Code (sec. 415) provides overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to contributions and benefits provided an individual under all qualified plans, tax-sheltered annuities, and SEPs maintained by any private or public employer or by certain related employers.

Under a profit-sharing or other defined contribution plan,[1] the qualification rules provide an overall limit on the annual addition with respect to each plan participant (sec. 415(c)). Generally, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000 adjusted for cost-of-living increases (CPI) since 1974. The limit for 1982 is $45,475. The defined contribution plan limit also applies to tax-sheltered annuities and SEPs.

Under a defined benefit pension plan[2] the annual benefit derived from employer contributions is subject to an overall limit of the lesser of (1) 100 percent of average compensation, or (2) $75,000, adjusted for cost-of-living increases (CPI) since 1974 (sec. 415(b)). The limit for 1982 is $136,425.

Maximum benefits payable upon early retirement

Under a defined benefit plan, the annual benefit is the equivalent of a retirement benefit for the life of the employee, beginning at age 55 or later, and without regard to certain survivor and nonretirement benefits. If the retirement benefit payments begin before age 55, the annual limitation ($136,425 for 1982) is actuarially reduced to the equivalent of the annual dollar limit at age 55.

Aggregate limit

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limits used by each plan is computed and the sum of the fractions is subject to an overall limit of 1.4. Under present law, the numerator of the defined benefit plan fraction is the projected annual benefit of the participant under the plan determined as of the close of the year and the denominator is the maximum benefit allowed under the Code.

The numerator of the defined contribution plan fraction is the total amount of annual additions to the participant's account through the close of the year and the denominator is the maximum amount of annual additions which could have been made for the participant if the plan provided the maximum allowable annual addition for the year and all prior years of service with the employer.

The sum of the fractions is subject to an overall limit of 1.4 under the qualification rules (sec. 415(e)). For example if the sum of the annual additions under the defined contribution plan is $^{5}/_{10}$ths of the annual additions which otherwise could have been made, then the annual benefit earned under the defined benefit plan may not exceed $^{9}/_{10}$ths of the defined benefit limit.

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[1] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants.

[2] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. (*e.g.*, a an annual benefit of two percent of average pay for each year of employee service).

Plans for self-employed individuals

A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an H.R. 10 plan or Keogh plan. Under a qualified profit-sharing or other defined contribution H.R. 10 plan, annual deductible contributions on behalf of a self-employed individual generally are limited to the lesser of $15,000 or 15 percent of net earnings from self-employment (sec. 404(e)). Under a qualified defined benefit H.R. 10 pension plan, the annual benefit accruals for a self-employed individual are limited by a special schedule designed to permit the accrual of an annual pension benefit no greater than that which could be provided by the accumulated annual contributions on behalf of a self-employed individual under a defined contribution H.R. 10 plan (sec. 401(j)).

A qualified pension or profit-sharing plan maintained by an electing small business corporation (a subchapter S corporation) is subject to special limitations corresponding to those for H.R. 10 plans. Under a qualified defined contribution plan of a subchapter S corporation, annual employer contributions on behalf of a shareholder-employee (an employee who owns more than five percent of the employer's stock) in excess of the annual deduction limit (the lesser of $15,000 or 15 percent of compensation) are includible in the income of the shareholder employee (sec. 1379(b)). Under a qualified defined benefit pension plan of a subchapter S corporation, benefits are limited under the same schedule that applies to a defined benefit H.R. 10 pension plan.

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), present law increases the annual IRA deduction limit by the lesser of $15,000 or 15 percent of compensation (sec. 219(b)(2)). The increased deduction limit for a SEP applies only to employer contributions.

Under present law, the limits for H.R. 10 plans, plans of subchapter S corporations, and SEPs are not automatically adjusted for cost-of-living increases.

Reasons for Change

The committee recognizes the importance of tax incentives in creating a strong pension system. At the same time, however, the committee believes it is necessary to provide more appropriate limitations to prevent excessive accumulations of tax-sheltered funds. Moreover, by reducing limitations on corporate plans, and increasing the deduction limits for 10 plans, the bill takes a significant step toward equalizing the treatment of plans benefiting only common law employees and plans for the self-employed.

Explanation of Provisions

Overview

The bill makes several changes to the overall limits on contributions and benefits. The maximum dollar limit on annual additions under defined contribution plans is decreased from $45,475 to $30,000, and the maximum dollar limit on the annual benefit payable under defined benefit plans is decreased from $136,425 to $90,000. Cost-of-living adjustments to these amounts are limited. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan is reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as under present law).

Under the bill, if the retirement benefit under a defined benefit plan begins before age 62, the $90,000 limitation is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62.

Under transition rules provided by the bill, benefits already earned by a plan participant as of July 1, 1982, are not affected by the reductions.

In addition, over a 3-year period, the bill increases from $15,000 to $30,000 the deduction limit for contributions on behalf of a self-employed individual to an H.R. 10 defined contribution plan. Similar increases are made with respect to defined benefit H.R. 10 plans.

Overall limits

Under the bill, the maximum dollar limit on annual additions for an employee under defined contribution plans of an employer is decreased from $45,475 to $30,000. The 25 percent of compensation limit is not changed.

The maximum dollar limit on employer-derived annual benefits for an employer under defined benefit plans of an employer is decreased from $136,425 to $90,000. The 100 percent of compensation limit is not changed. Further, under the rules relating to the overall limit on annual benefits, benefits paid in a form other than a single life annuity may not exceed that amount which, when converted to a single life annuity using an interest rate assumption of at least 5 percent, would produce a single life annuity equal to the applicable limit.

As under present law, if a benefit is paid in the form of a joint and survivor annuity for the benefit of the participant and his spouse, the survivor benefit is not taken into account unless the survivor benefit is greater than the joint benefit. As under present law, the maximum allowable benefit is also reduced for an employee with less than 10 years of service with the employer.

The bill suspends cost-of-living adjustments to the overall dollar limits. The $30,000 and $90,000 limits, first effective in 1983, may not be increased in 1984 or 1985. Beginning in 1986, these limits will be adjusted for post-1984 cost-of-living increases, measured by the formula then in effect to provide cost-of-living increases in social security benefits. Beginning in 1986, cost-of-living adjustments will also apply to the dollar limits applicable to H.R. 10 plans, plans maintained by subchapter S corporations and SEPs.

For 1983, 1984, and 1985 no change is made to the present-law provision for defined benefit plans which permits adjustment of the 100 percent of compensation limit to reflect post-separation cost-of-living increases for participants who have separated from service. Thereafter, permitted post-separation adjustments will be made under the rules providing adjustments to the overall dollar limits.

The bill clarifies present law by providing that anticipated cost-of-living adjustments to the overall benefit limits may not be taken into account under the rules relating to the deduction allowed for employer contributions to a qualified defined benefit pension plan.

Maximum benefits payable upon early retirement

Under the bill, if retirement benefits under a defined benefit plan begin before age 62, the $90,000 limitation (but not the 100 percent of compensation limit) is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. Under the bill, the reduction is to be computed using an interest rate assumption of at least 5 percent. As under present law, there is no required reduction for pre-retirement ancillary benefits (such as medical, death, or disability), but adjustments are required to reflect post-retirement ancillary benefits such as term-certain annuities, post-retirement death benefits, etc.

This provision does not prevent an employee from retiring prior to age 62, and it does not mandate actuarial reductions in all plan benefits commencing prior to age 62.

Aggregate limit

With regard to the aggregate limit applied with respect to an employee who participates in both a defined benefit and defined contribution plan of the same employer, the bill redefines the defined benefit plan and the defined contribution plan fractions used to compute the limit. Under the bill, the aggregate limit is the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (determined as under present law).

Under the bill, the aggregate limit may not exceed 1.25, but the revised plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied only to the dollar limits) or 1.4. The numerator of the defined benefit fraction is the projected annual benefit determined as of the close of the year and the denominator is the lesser of (i) the amount determined under the applicable percentage of compensation limit, multiplied by 1.12 (i.e. 1.4÷1.25) or (ii) the maximum dollar limit (e.g., $90,000 for 1983).[3]

The numerator of the defined contribution fraction is the total amount of annual additions to the participant's account through the close of the year, and the denominator is the sum (for all year of an employee's service) of the lesser (for each such year) of two amounts. The first amount is the amount determined under the percentage of compensation limit for such year, multiplied by 1.12. The second amount is the maximum dollar limit for such year (e.g., $30,000 for 1983).[4]

Plans for self-employed individuals

The bill increases from $15,000 to $30,000 the deduction limit for contributions on behalf of a self-employed individual to a defined contribution H.R. 10 plan. Under the bill, the limit is $20,000 for 1983, $25,000 for 1984, and $30,000 for 1985. The 15 percent of earnings limit is not changed. These increases also apply to excludible contributions on behalf of a shareholder-employee to a plan maintained by a subchapter S corporation and to employer contributions to a simplified employee pension (SEP).

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[3] However, if the participant's current accrued benefit determined pursuant to the transitional rules exceeds $90,000, the denominator of the defined benefit fraction would be the lesser of (1) the percentage of compensation limit multiplied by 1.12, or (2) the dollar amount of the current accrued benefit.

[4] The dollar amount used to compute that denominator for any year is the actual dollar amount in effect for that year (e.g., $45,475 for 1982, $41,500 for 1981, etc.).

A corresponding revision increases permitted accruals under a defined benefit H.R. 10 plan. The compensation that may be taken into account in determining permitted annual benefit accruals for an owner-employee is increased from $100,000 in 1982 to $133,000 for 1983, $167,000 for 1984, and $200,000 for 1985 and will be adjusted for subsequent years to reflect cost-of-living increases. These increases also apply with respect to permitted annual benefit accruals on behalf of a shareholder-employee under a defined benefit plan of a subchapter S corporation.

To prevent retroactive increases in permitted benefit accruals, the bill continues the requirement of present law under which an increase in the compensation taken into account to determine benefit accruals under a plan is treated as starting a new period of plan participation (but only with respect to such increase).

Effective Dates

In general

For plans not in existence on July 1, 1982, the provisions reducing the overall limits apply to years ending after the date of enactment. For plans in existence on July 1, 1982, the provisions generally apply to years beginning after December 31, 1982. For purposes of the qualification rules (sec. 401(a)(16)), a plan which was in existence on July 1, 1982, will not fail to be qualified for any year beginning before January 1, 1984, merely because the plan may provide benefits or contributions which, though not exceeding the overall limits in effect prior to the amendments made by the bill, exceed those limits as amended.

Thus, deductions for years beginning after December 31, 1982, will be limited to those amounts required to fund the lower limits provided by the bill (whether or not contributions required by the plan exceed those limits). However, plan amendments will be required to be made no later then the last day of the first plan year beginning after December 31, 1983, effective as of the first day of such plan year.

The provisions which suspend the cost-of-living adjustments apply to adjustments for years beginning after December 31, 1982, and before January 1, 1986. Thus, any adjustment to the overall dollar limits which would otherwise take effect after December 31, 1982, and before January 1, 1986, shall not take effect.

The provisions increasing the limits on H.R. 10 plans, plans maintained by subchapter S corporations and employer contributions to SEPS apply to taxable years beginning after December 31, 1982.

Transitional rules

The bill also provides a transitional rule to insure that a participant's previously accrued benefit is not reduced merely because the bill reduces the overall limits on contributions and benefits. The rule applies to an individual who is a participant before January 1, 1983, in a plan which was in existence on July 1, 1982. If such an individual has a current accrued benefit which exceeds the applicable dollar limit under the bill (but which does not exceed the applicable dollar limit in effect prior to the bill), then the applicable dollar limit for such individual is equal to such current accrued benefit. Similarly, in computing the participant's defined benefit fraction, under the bill, such current accrued benefit would replace the maximum dollar limit otherwise used in the denominator of the fraction.

Under the bill, an individual's current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before January 1, 1983, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the bill. Thus, for example, the annual benefit could be computed without requiring any actuarial reduction for benefits commencing before age 62 and after age 55. For purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after July 1, 1982, is taken into account. Thus, for example, if an individual's current accrued benefit is a special percentage of his average pay, rather than a specified amount, the current accrued benefit is the specified percentage of average pay computed as of the close of the last year beginning before 1983. Similarly, cost-of-living adjustments occurring after 1982 are not taken into account.

Employers would be required to continue contributions to fund an individual's current accrued benefit. However, no further accruals would be permitted for an individual whose current accrued benefit exceeds the dollar limit until the usual the dollar limit, as adjusted for cost-of-living increases, exceeds the individual's current accrued benefit.

Transitional rules are provided for individuals who participate in both a defined contribution and a defined benefit plan of the same employer. A plan will not fail to be qualified merely because a participant's aggregate limit exceeds 1.25, determined under the bill's provisions (but does not exceed 1.4, as in effect prior to the amendments made by the bill). However, additional accruals for such a participant are generally precluded until the combined fractions do not exceed 1.25.

The bill also provides a special, elective transitional rule for computing the defined contribution plan fraction. The rule allows the computation for pre-1983 years to be based solely upon an adjusted 1982 defined contribution plan fraction.

2. Loans to plan participants (sec. 248 of the bill and sec. 72 of the Code)

Present Law

Qualified pension, etc., plans

A qualified pension, etc., plan (including a plan which provides a qualified cash or deferred arrangement) generally is permitted to make a loan to a plan participant if certain requirements are met. Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 4975(d)). However, a qualified plan benefiting a self-employed individual (an H.R. 10 plan) is not permitted to lend to an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), and a plan of an electing small business corporation (a subchapter S corporation) is not permitted to lend to a shareholder-employee (an employee owning more than 5 percent of the corporation's stock). Also, if a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the transaction is treated as a plan distribution and the usual income tax rules for distributions apply (sec. 72(m)). Loans are also permitted under tax-sheltered annuity contracts.

IRAs

Under present law (secs. 72(m) and 408(e)) if an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual income tax rules for IRA distributions apply. Rules corresponding to the IRA provisions apply with respect to loans from accumulated deductible employee contributions under an employer's plan and to the use of the accumulated contributions as security for a loan (sec. 72(o)).[1]

Reasons for Change

The committee is concerned that widespread use of loans from tax-qualified plans and tax-sheltered annuities diminishes retirement savings. Accordingly, the committee concluded that restrictions on loans and pledges should be applied to all plan participants. However, the committee is also concerned that an absolute prohibition against loans might discourage retirement savings by rank-and-file employees who may need access to such monies for emergencies. Thus, the committee believes it appropriate to permit smaller loans which will not substantially diminish an employee's retirement savings.

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[1] For taxable years beginning after 1981, an employee is allowed a deduction for voluntary contributions to a plan if certain requirements are met (sec. 219). The annual deduction is limited to the lesser of $2,000 or 100 percent of the employee's compensation, and is in lieu of the deduction allowed for contributions to an IRA.

Explanation of Provision

Loans treated as distributions

The bill leaves unchanged the present rules treating as distributions loans to self-employed individuals from H.R. 10 plans and loans from IRAs or from accumulated deductible employee contributions under employer plans. The bill provides loan rules which apply with respect to all other participant loans from qualified pension, etc., plans and tax-sheltered annuities (including a custodial account investing in stock of a regulated investment company).

Under the bill, certain loan transactions with a qualified pension, etc., plan or a tax-sheltered annuity are treated as distributions. Applicable loan transactions generally include the direct or indirect receipt of a loan from a qualified plan or tax-sheltered annuity, the assignment (or agreement to assign), and the pledging (or agreement to pledge) any portion of an employee's interest in a plan or the value of any contract purchased under a qualified plan. However, any loan to a self-employed individual from an H.R. 10 plan, or any loan from an IRA would not be considered an applicable loan transaction under the bill.

The determination as to whether a transaction is treated as an applicable loan transaction is made at the time of the transaction by aggregating the amount of the transaction (principal plus interest) with the outstanding balances of all other applicable loan transactions made to the participant under all qualified plans or tax-sheltered annuities whether or not such plans are maintained by the same employer. To the extent that the aggregate amount exceeds $10,000, the excess (limited to the amount of the present applicable loan transaction) will be treated as a distribution under the plan or contract. Under the bill, the usual income tax rules for distributions would apply.[2] Thus, to the extent such excess is greater than the amount of nondeductible employee contributions, the excess will be includible in gross income. For example, if a participant who had contributed $5,000 of nondeductible employee contributions (but no deductible employee contributions) borrowed $16,000 from a plan, $6,000 (the amount in excess of $10,000) will be treated as a distribution. Under the distribution rules, the participant is deemed to receive first has nondeductible contribution of $5,000. Thus, the only amount included in the participant's gross income will be $1,000.

A failure to pay loan interest when due will constitute an indirect loan for purposes of the bill, unless under the facts and circumstances such a failure does not constitute an additional loan transaction. Similarly, with regard to a loan amount outstanding on July 1, 1982, a failure to repay loan principal when due will constitute an indirect loan for purposes of the bill unless, under the facts and circumstances, the failure does not constitute an additional loan transaction.

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[2] However, a loan (including a loan made to a self-employed individual under an H.R. 10 plan) which constitutes a distribution is not eligible for the special 10-year income averaging rules, long-term capital gain treatment, or tax-free rollover treatment otherwise available to certain distributions under tax-qualified plans or tax-sheltered annuities.

The committee intends that if a plan invests in participant loans fully secured by property (e.g., real estate mortgages) in the ordinary course of its investment program, such investments will not be treated as distributions under the bill where the loans are not primarily secured by the participants' benefits under the plan.

Of course, where a loan would be treated as a distribution under present law, the bill does not change the result.

Loan repayments

Repayments of loans (including loans treated as distributions) will not be not considered employee contributions for purposes of those rules limiting nondeductible employee contributions and annual additions on behalf of an employee under qualified plans (and tax-sheltered annuity contracts) or those rules allowing the employee a deduction for certain voluntary contributions under an employer's plan.

For purposes of the income tax rules governing distributions, repayments of amounts previously treated as distributions are to be treated as nondeductible employee contributions. Under this rule, a distribution will be tax-free to the participant to the extent it includes such repayments. Accordingly, the participant is not taxed on the same amount twice (at the time of the loan and again when the repaid amount is distributed.

Plan qualification

The bill makes no changes to the present-law prohibited transaction rules and fiduciary standards for qualified pension, etc. plans. Thus, the bill does not revise present-law provisions requiring that a plan loan bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Although the bill changes the tax treatment of certain plan loans, the bill does not modify the tax-qualification standards of the Code for pension, profit-sharing, or stock bonus plans or the non-Code rules of ERISA. For example, the tax qualification of a plan is not adversely affected merely because an amount is treated as distributed to a participant under this provision at a time when the plan is not permitted to make a distribution to the participant.

Similarly, the status of a custodial account investing in stock of a regulated investment company (sec. 403(b)(7)) is not adversely affected on account of a loan being treated as a distribution under the bill.

Reporting

To insure that the loan rules can be administered on an individual basis, the bill requires that plan administrators and issuers of tax-sheltered annuities provide an annual report describing all loans whether or not such loans are treated as distributions.

The report is to include the outstanding balance of any applicable loan transaction, as of the beginning of the year, the amount of any applicable loan transaction entered into during the year, the name, address, and taxpayer identification number of the participant and such other information as the Secretary of the Treasury may require. Under the bill, this report is to be furnished to the Secretary and to such other persons (including the affected participant) as the Secretary requires.

The Secretary may also require an employee who has received a loan to furnish the plan with information, such as information regarding the repayment of a loan or any amount the employee included in his income.

Effective Date

The bill applies to applicable loan transactions made after July 1, 1982. Amounts outstanding on July 1, 1982, which are renegotiated, extended, renewed, or revised after July 1, 1982, are to be treated as made on the date of the renegotiation, etc. Accordingly, an individual having an outstanding loan balance on July 1, 1982, in excess of $10,000 is not affected by the bill's provisions except to the extent that additional plan loans are made to the individual or an existing loan is renegotiated, etc.

3. Retirement savings for church employees (sec. 251 of the bill and secs. 403 and 415 of the Code)

Present Law

Under present law (sec. 403(b)), public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make contributions on behalf of an employee to purchase a tax-sheltered annuity contract. Contributions to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted. The amount contributed by the employer is excluded from the employee's income for the taxable year to the extent such amount does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includable compensation from the employer multiplied by the number of the employee's years of service with that employer, and is reduced by amounts already contributed by the employer to purchase the annuity.

Employer contributions to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limit on annual additions to tax-qualified defined contribution plans (sec. 415(c)). Under the overall limit, annual additions [1] to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of (1) $25,000 adjusted for post-1974 cost-of-living increases ($45,475 in 1982), or (2) 25 percent of the employee's compensation from the employer for the year. Under a special rule (sec. 415(c)(4)(C)), an employee of an educational institution, hospital, or home health service agency may elect to compute the annual exclusion allowance for contributions to a tax-sheltered annuity solely by reference to the maximum annual employer contribution which may be made under the overall limit. This rule applies to employees of a church hospital, etc., but not to other church employees.

In addition, to allow certain lower-paid employees catchup contributions (i.e., contributions permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit which takes into account only the current year), present law provides alternative special elections which increase the overall limit for the year of the election. An individual is allowed only one of the special elections under section 415 during his lifetime. The first alternative catchup election (sec. 415(c)(4)(A)) may be made only for the year of an employee's separation from the service of the contributing employer (the separation year catchup election). The second alternative catchup election (sec. 415(c)(4)(B)) generally may be made for any year, but is subject to limitations to which the separation year catchup election is not. Of course, neither election increases the amount excludable from the employee's income for the year under the exclusion allowance. The alternative catchup elections are available to church and nonchurch employees of educational institutions, hospitals, and home health services, but not to other church employees.

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[1] Annual additions consist of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants.

Reasons for Change

The committee believes that the present-law provisions relating to tax-sheltered annuities often make it difficult for churches to provide ministers and lay employees adequate retirement income. The formula for fixing an employee's annual exclusion allowance may not reflect the career pattern of a minister or lay employee who moves from one employing organization to another within a church. In addition, the formula does not take into account the historically low salaries paid to ministers and other church employees.

The committee also believes that the tax treatment of retirement savings provided church employees by an associated organization, such as a church pension board, should be clarified.

Explanation of Provision

In general

The bill revises the present-law rules relating to tax-sheltered annuity programs maintained by churches for their employees. The bill generally increases the ability of churches to provide retirement income for their employees and clarifies the status of such programs. For purposes of the bill's provisions, the term church includes a convention or association of churches, or an organization which is exempt from tax and is controlled by or associated with a church or a convention or association of churches. Church employees include duly ordained, commissioned, or licensed ministers and lay employees, including employees of tax-exempt organizations (whether civil law corporations or otherwise organized) which are controlled by or associated with a church.

Exclusion allowance increased

The bill generally increases the annual exclusion allowance for church employees whose adjusted gross income for the year does not exceed $17,000. Thus, an employee's eligibility for the increased exclusion allowance is determined by taking into account both includible compensation paid by the church and income from other sources. However, for this purpose an employee's adjusted gross income does not include income attributable to the employee's spouse.

Under the bill, the exclusion allowance for an eligible church employee is not less than the lesser of $3,000 or the employee's includible compensation for the year. Solely for the purpose of determining includible compensation under the special rule, the includible compensation of an eligible church employee who is a foreign missionary is considered to include the amount contributed by the church during the taxable year for the purchase of a tax-sheltered annuity for the employee. A church employee is a foreign missionary for a taxable year for which the employee's principal duties are the propagation of religious doctrine or the performance of sacerdotal functions or humanitarian good works for the church outside the United States.

The bill also provides that for purposes of the exclusion allowance, all years of an employee's service with an organization that is a part of a particular church are treated as years of service with one employer. Thus, although a minister or lay employee may, during the span of a career with a church, transfer from one organization to another within the particular church, or from the church to an associated organization, all service with such organizations is treated as service with a single employer. Contributions made by all such organizations on behalf of an employee will also be taken into account under the exclusion allowance formula as contributions made by a single employer. While this rule applies for computing post-1981 exclusion allowances, pre-1982 service with, and pre-1982 contributions by a particular church (as defined by the bill) are taken into account under the computations.

The bill makes available to all church employees the present-law special elections permitted under the overall limit. The bill also permits a church employee an additional election pursuant to which the church may make contributions for the year in excess of the otherwise applicable overall annual limit. Contributions permitted for a church employee under this provision are limited to $10,000 for any one year and to $40,000 for the employee's lifetime. Of course, contributions made pursuant to the election are excludable from the employee's income only if they are otherwise permitted under the employee's exclusion allowance for the taxable year. In addition, the election may not be made for the taxable year for which the separation year catchup election is made (sec. 415(c)(4)(A)).

Retirement income accounts maintained by churches

The bill also provides that generally the tax rule relating to tax-sheltered annuity contracts apply to retirement income accounts provided by a church for its employees. Under the bill, a retirement income account means a program established or maintained by a church to provide retirement benefits for its employees under the tax-sheltered annuity rules. Thus, a church-maintained retirement income account differs from a tax-sheltered annuity only in that the account is not maintained by an insurance company. The committee intends that the assets of such a retirement income account may be commingled in a pooled account or common fund made up of such accounts but may not generally be commingled with other assets. The committee intends that, solely for purposes of diversifying plan investments, the assets of a retirement income account may be pooled with the assets of a tax-qualified plan without adversely affecting the status of the account or the tax qualification of the plan if the account, like the plan, is for the exclusive benefit of employees and precludes diversion of assets. Of course, any pooled account or common fund is subject to the fiduciary standards (including the rules relating to prohibited transactions) of the Employee Retirement Income Security Act of 1974 [ERISA] if any participating trust is subject to those standards.

The bill adds rules under which a church maintaining a tax-sheltered annuity program or retirement income accounts is permitted a retroactive amendment period with respect to provisions of the program which are inconsistent with applicable Code provisions. These rules will permit retroactive amendments and are similar to those now applicable with respect to tax-qualified pension, etc., plans (sec. 401(b)). The Committee intends that, in applying the retroactive amendment rules, the Secretary of the Treasury will take into account that church governing bodies typically meet at lengthy intervals.

Effective Dates

The provisions generally apply to taxable years beginning after December 31, 1981. The provisions relating to the overall limits apply to years beginning after that date. The retroactive amendment period rules apply as of July 1, 1982, and permit amendments of programs to correct defects in existence on that date.

The provision relating to retirement income accounts provided by a church for its employees is effective for taxable years beginning after December 31, 1974.

4. Certain State judicial retirement plans (sec. 252 of the bill and sec. 457 of the Code)

Present Law

Eligible State deferred compensation plan

Under present law (sec. 457(a)), employees of a State or local government or a rural electric cooperative are permitted to defer compensation under an eligible State deferred compensation plan if the deferral does not exceed prescribed annual limits (generally the lesser of $7,500 or 33⅓ percent of includible compensation). Amounts deferred by a participant in an eligible plan, plus any income attributable to the investment of such amounts, are includible in the income of the participant or the participant's beneficiary only when paid or otherwise made available under the plan.

Treatment of participants in an ineligible plan

If a deferred compensation plan of a State or local government fails to meet the requirements of an eligible plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture (sec. 457(e)). If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the income of participants or beneficiaries in the first taxable year in which there is no substantial risk of forfeiture.

This rule for the tax treatment of participants in an ineligible plan does not apply, however, if the tax treatment of a plan participant is governed by tax rules for the plan that are set forth elsewhere in the Code. For example, the rule does not apply if the ineligible plan is a qualified pension plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), or includes a trust forming a part of a nonqualified pension plan (sec. 402(b)).

Reasons for Change

An eligible State deferred compensation plan is a defined contribution plan under which a plan participant is entitled to his account balance consisting of the deferred amounts plus earnings. Retirement plans for State judges are sometimes defined benefit plans under which a participant is entitled to a retirement benefit based upon the pay of sitting judges. Because the participant's benefit under such a plan generally does not depend upon the participant's account balance, the committee believes it is inappropriate to apply contribution limits or other rules designed for defined contribution plans.

Explanation of Provision

Under the bill, participants in a qualified State judicial plan are not subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited.

A State's retirement plan for the exclusive benefit of its judges or their beneficiaries is a qualified State judicial plan if (1) the plan has been continuously in existence since December 31, 1978, (2) all judges eligible to benefit under the plan are required to participate and to contribute the same fixed percentage of their basic or regular rate of compensation; and (3) a judge's retirement benefit under the plan is a percentage of the compensation of judges of the State holding similar positions.

In addition, the plan may not pay benefits with respect to a participant which exceed the limit on benefits permitted under qualified plans, and may not provide an option to plan participants as to contributions or benefits the exercise of which would affect the amount of the participant's currently includible compensation.

Effective Date

The provision applies to taxable years beginning after December 31, 1978.

5. Contributions for disabled employees (sec. 253 of the bill and secs. 404 and 415 of the Code)

Present Law

In order to limit the extent to which individuals can use tax-favored arrangements to provide for retirement, the plan qualification rules (sec. 415) provide overall limits on contributions and benefits under qualified pension, etc., plans.

Under a profit-sharing or other defined contribution plan, the qualification rules provide an overall limit on the annual addition with respect to each plan participant (sec. 415(c)). Generally, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000 adjusted for cost-of-living increases (CPI) since 1974. The limit for 1982 is $45,475.

Because annual additions for an employee are limited to 25 percent of the employee's compensation, contributions generally may not be made on behalf of an employee who has separated from service.

Reasons for Change

The committee concluded that it is appropriate to increase the retirement income security of disabled employees by permitting an employer to make contributions to a profit-sharing or other defined contribution plan on their behalf.

Explanation of Provision

The bill permits an employer to elect to continue deductible contributions to a profit-sharing or other defined contribution plan on behalf of an employee who is permanently and totally disabled. An individual is considered permanently and totally disabled if the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of at least 12 months.

Under the bill, annual additions with respect to a plan participant (consisting of employer contributions, certain employee contributions, and forfeitures) are limited to the lesser of (1) 25 percent of compensation or (2) $30,000. Under the bill, for purposes of the limit, the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled.

In addition, the bill requires that the plan provide that disabled employees on whose behalf an employer elects to make contributions are to be fully and immediately vested in benefits derived from these contributions. Thus, where a disabled participant is not fully vested in the accrued benefits derived from other employer contributions, the plan will be required to maintain a separate account for these disability contributions.

The bill does not permit disability contributions on behalf of disabled employees who were officers, owners, or highly compensated.

Effective Date

The provision applies to years beginning after December 31, 1981.

6. Participation in group trusts by governmental plans (sec. 254 of the bill and sec. 401 of the Code)

Present Law

Group trusts

Under present law, trusts that are parts of qualified pension, profit-sharing or stock bonus plans or individual retirement accounts (IRAs) may pool their assets in a group trust, usually created for the purpose of diversifying investments. If certain requirements are met, the pooling of assets does not affect the tax-exempt status of the contributing trusts, and the group trust itself is exempt from tax (Rev. Rul. 81-100, 1981-1 C.B. 326).

Governmental plans

Under present law, a funded pension plan, including a governmental plan,[1] is a qualified plan if it meets certain requirements of the Internal Revenue Code. Also, a trust forming a part of a qualified pension plan is exempt from tax as a qualified trust if (1) employer contributions to the trust are made for the purpose of distributing the corpus and income to employees and their beneficiaries, and (2) under the trust instruments it is impossible for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees before the liabilities to employees and their beneficiaries are satisfied. In addition to other tax-qualification requirements, the plan must not discriminate in coverage or in contributions or benefits in favor of employees who are shareholders, officers or highly compensated. Also, contributions or benefits must not exceed specified limits.

The Internal Revenue Service has announced that issues concerning prohibited discrimination in coverage or in contributions or benefits under governmental plans will not be raised by the Service until a review of the antidiscrimination rules is completed.[2] The Service announced that it is reconsidering the application of the antidiscrimination rules to plans covering elected and appointed officials of State and local governments. Pending completion of its review, the Service will resolve any issue under the rules in favor of a governmental plan's retaining its tax-qualified status.

Under present law, a trust forming a part of a government plan is not exempt from tax if the trust engages in specific prohibited transactions described by the Code.

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[1] A government plan is a plan established and maintained for its employees by the Government of the United States, by any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

[2] I.R.S. News Release IR-1869, August 10, 1977.

Reasons for Change

The committee understands that trustees of group trusts often are reluctant to allow governmental plans to participate in the trust on account of uncertainty as to the qualified status of such plans. The committee believes it appropriate to remove this barrier to participation in group trusts by funded governmental plans.

Explanation of Provision

Under the bill, the tax-exempt status of a group trust will not be adversely affected merely because a participating trust is part of a funded governmental pension plan which is, or is treated as, a tax-qualified plan. A group trust is subject to the fiduciary standards (including the rules relating to prohibited transactions) of the Employee Retirement Income Security Act of 1974 (ERISA) if a participating trust is subject to the standards. Such a group trust will remain subject to the standards, even though a participating trust is a trust which is a part of a governmental plan.

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

7. Revenue effect of pension provisions

It is estimated that the pension provisions will increase budget receipts by $211 million in fiscal year 1983, $588 million in 1984, $673 million in 1985, $762 million in 1986, and $848 million in 1987.

E. Taxation of Life Insurance Companies and Annuities

1. Repeal of modified coinsurance provisions (secs. 256, 257, 258, and 259 of the bill and secs. 805, 811, 818 and 820 of the Code)

Present Law

A life insurance company sometimes will insure itself against some policyholder risks it has undertaken. This type of insurance between insurance companies is referred to as "reinsurance". Modified coinsurance, commonly referred to as "Modco", is a type of reinsurance agreement under which the company transferring some of its risks (the "ceding" company) retains ownership of the assets connected with the risks reinsured and also retains the reserve liabilities connected with the risks reinsured. In consideration, the company which has agreed to assume the risks under the agreement (the "reinsurer") receives both premium income and investment income attributable to the policies reinsured from the ceding company. Thereafter, periodic settlements are made between the companies for premiums collected, benefits paid, etc.

Present law (Code sec. 820) contains a rule which allows the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income for the reinsured policies and the investment income on the assets were received directly by the reinsurer, and also as if reserves to reflect liability for future claims were maintained by the reinsurer. No transfer of assets actually occurs.

Reasons for Change

The present law provision (Code sec. 820) was originally intended to avoid possible double taxation to both the ceding company and the reinsurer when a modified coinsurance agreement is used. However, some life insurance companies have used modified coinsurance to avoid or substantially reduce income tax paid by both the reinsurer and the ceding company. For example, since a life insurance company cannot deduct policyholder dividends in excess of underwriting income (plus $250,000), it would benefit by converting investment income into underwriting income which then may be offset by excess policyholder dividends which would not otherwise be deductible. Similarly, a company with gain from operations exceeding its investment income, but without sufficient dividends to offset all underwriting income, would benefit by converting investment income into underwriting income because the tax on half of the underwriting income is deferred.

Any increased income to the reinsurer because of the deemed transfer of investment income could be offset by an "experience refund" to the ceding company equal to the investment income minus a minor "service charge." Moreover, a reinsurer may receive an additional benefit of sheltering its other income if it has elected the approximate method for revaluing reserves computed on a preliminary term basis.

Thus, the effect of entering into a modified coinsurance agreement with a section 820 election has often been to convert taxable investment income into underwriting income on which a lesser or no tax is paid by the ceding company and to reduce gain from operations for the reinsurer.

Explanation of Provisions

Modified coinsurance rules

The Committee bill will repeal the modified coinsurance rules under present law (Code sec. 820). The repeal will apply, as of January 1, 1982, for purposes of computing the life insurance company's taxable income, i.e., for purposes of determining taxable investment income and gain from operations. Subject to special termination accounting rules, the repeal will apply to the treatment of modified coinsurance contracts entered into prior to 1982 for taxable years beginning after December 31, 1981.[1]

Conforming change for policyholder dividends under conventional coinsurance

The modified coinsurance rules under present law (Code sec. 820(c)(5)) provide that the dividends paid in respect of a reinsured policy are treated as paid by the reinsurer and not the reinsured (to the extent the reinsurer reimburses the reinsured). This rule also applies in respect of an insurance or annuity policy reinsured under a conventional coinsurance contract as well as a modified coinsurance contract.

As a conforming change with the repeal of the modified coinsurance provisions, the committee bill incorporates the existing rules for conventional reinsurance contracts under the policyholder dividend provisions (sec. 811). However, the provisions added will also reverse a decision of the Court of Claims[2] which held that a reinsurer's dividend deduction was limited to amounts actually paid in dividend reimbursements and did not include a reserve for dividend reimbursements. Thus, unlike the general rules relating to the amount of deductible policyholder dividends (sec. 811(b)) which prescribe an accrual method, a reinsurer was placed on a cash method under the Court of Claims decision for purposes of deducting reimbursed policyholder dividends. Under the committee bill, an accrual method will be consistently applied to determine the amount of policyholder dividends treated as paid by the reinsurer and not by the reinsured company.

Under the provision, amounts treated as paid by a reinsurer will not be considered to have been paid by the ceding company. Accordingly, the reinsurer and not the ceding company will take the amounts into account for purposes of determining the limitation on policyholder dividends and other special deductions provided under the bill (Code sec. 809(f) as amended).

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[1] For taxable years beginning before 1982, the provisions of present law will apply with respect to those taxable years even if the consent of the reinsured and reinsurer required under present law is submitted with income tax returns that are timely filed after 1981.

[2] *Lincoln National Life Ins. Co.* v. *U.S.*, 582 F. 2d 579 (1978).

Special termination accounting rules

The bill prescribes special accounting rules for unwinding the tax treatment of modified coinsurance contracts in effect on December 31, 1981, to which the modified coinsurance rules of present law apply. Generally, those contracts are to be treated as terminated on January 1, 1982, for most purposes under the provisions of the bill.

As of the beginning of the first taxable year beginning after 1981, the reserves and the assets in relation to the reserves are to be treated as reserves and assets of the reinsurer (assuming) company and not of the reinsured (ceding company). At the end of that year, the assets and reserves will be treated as having been returned to the ceding company. By treating the assets and reserves as having been returned during the taxable year, the related tax consequences with respect to the deemed termination[3] will be treated in a manner consistent with the original transaction which occurred after the beginning of a taxable year and thereby did not affect opening asset and reserve amounts for that taxable year.

Beginning with the first taxable year after 1981, all of the gross investment income derived from the assets is to be treated as the gross investment income of the ceding company. No portion of gross investment income earned after 1981 is to be treated as the income of the assuming company. Similarly, all premiums collected after 1981 are to be included in premium income of the ceding company and not that of the reinsurer. Finally, expenses and policyholder dividend deductions attributable to the reinsured policies will be deductible only by the ceding company after 1981.

In general, the assuming company will be allowed a deduction in determining gain or loss from operations for an amount equal to the "termination amount" (generally reflecting the assets considered returned to the ceding company) and will reflect an increase in income in determining gain from operations attributable to the decrease in reserves with respect to the policies reinsured (section 810). The deduction for the termination amount will be allowed only as an other trade or business deduction (section 809(d)(11)) and cannot be taken into account for purposes of any other deduction (including treatment as an offset to premium income under section 809(c)(1)). For purposes of the Committee bill, the "termination amount" means the amount, determined under Treasury regulations, that the assuming company would have returned to the ceding company upon termination of the contract if it had been terminated as of January 1, 1982. In general, this amount will reflect the basis or value of the assets relating to the reinsured policies. The provision is not intended to disallow deductions for other actual payments made by the reinsurer in connection with the contract, e.g., reimbursements for claims, etc.

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[3] Thus, the computations of the mean of the assets and reserves taken into account for purposes of allocating the excludable portion of investment yield to policyholders under sections 804(a) and 805 will not include these assets and reserves in the opening or beginning assets and reserves of the ceding company.

In cases where an assuming company recognizes income for reserve decreases in excess of the deduction for the termination amount, special rules are provided to permit payment of the tax attributable to the excess in 3 annual installments. Under this provision, an assuming company may elect to pay the additional tax in three equal annual installments beginning March 15, 1983, the due date for the corporate return for calendar year 1982. However, for the installment due on March 15, 1983, the taxpayer could defer paying one-half of that installment until June 15, 1983. No interest will be charged on the deferred payments. For purposes of the provision, the amount eligible for deferred payment will be equal to the amount by which (1) the net income tax liability for the first taxable year beginning in 1982 (after credits other than for estimated taxes) which is determined by taking the amounts allocable to the modified coinsurance contract termination treatment into account, exceeds (2) the net income tax liability determined without regard to the amounts allocable to the termination treatment. Special rules are also provided with respect to acceleration of unpaid installments if a payment is not made when due, proration of deficiencies to installments, posting of any bond required by the Secretary of the Treasury, and tolling of the period of limitations for making assessments with respect to the collection of tax attributable to the contracts treated as terminated.

The ceding company will include an amount equal to the termination amount in its gross income for its first taxable year beginning after 1981 (as other income under Code section 809(c)(3)) and, subject to a special limitation, take the increase in reserves for the contracts into account in computing gain or loss from operations (Code section 810). Under a special limitation designed to limit revenue losses, the increase in reserves taken into account for 1982 will be limited to the termination amount included in income. The beginning reserves for the next taxable year will reflect the full amount of the reserves without any reduction attributable to the special limitation.

Denial of interest deduction on indebtedness incurred in connection with reinsurance agreements

To discourage the use of conventional reinsurance agreements for tax avoidance purposes similar to those involved with modified coinsurance, the Committee bill denies interest deductions otherwise taken into account in allocating investment income to policyholders (Code section 805) if the interest is incurred after December 31, 1981, by a ceding company, or its affiliates, in connection with a coinsurance contract. This provision will not apply to interest paid on account of delay in making periodic settlements of income and expense items under the terms of the contract.

The Committee intends that no inference is to be drawn from the inclusion of the limited specific rules for debt-financed conventional coinsurance arrangements but not for other arrangements. In appropriate circumstances, the Internal Revenue Service may challenge other conventional coinsurance contracts on other grounds, e.g., on the basis of lack of economic substance of a transaction, the lack of a bona fide business purpose, or the fact that the agreement is not an insurance agreement.

Treasury allocation authority for related party coinsurance contracts

The bill also grants authority for the Internal Revenue Service to reallocate or recharacterize items related to a reinsurance contract between related persons if the Service determines that it is necessary to reflect the proper source and character of taxable income of the parties (including any item used in determining taxable investment income and gain from operations). This provision may be applied by the Service to reinsurance arrangements involving an affiliated casualty insurance company. This provision may also apply to a contract even if one of the related parties is not a domestic life insurance company.

Modified coinsurance grandfather protection

For taxable years beginning before January 1, 1982, the bill provides that, except in the case of fraud, the determination of whether a contract satisfies the modified coinsurance definitional requirements under present law (Code sec. 820(b)) is to be made solely by reference to the terms of the contract. Also, the bill provides that the rules governing the tax treatment of items relating to a modified coinsurance contract for those taxable years (Code sec. 820(c)) are to be applied in accordance with the Treasury regulations in effect on December 31, 1981.

Effective Dates

The repeal of the modified coinsurance rules and the conforming change for the treatment of policyholder dividends by an assuming company for conventional coinsurance contracts apply to taxable years beginning after December 31, 1981.

The special termination accounting rules for modified coinsurance contracts apply to a taxpayer's first taxable year beginning after 1981.

The provision denying interest deductions with respect to certain coinsurance contracts applies to interest paid or accrued after 1981.

The provision granting special allocation authority to the Internal Revenue Service with respect to conventional coinsurance arrangements between related parties applies to contracts entered into after the date of enactment of the Act.

2. Policyholder dividends (secs. 261 and 265 of the bill and sec. 809 (d) (3), (5) and (6) and (f) of the Code)

Present Law

In addition to ordinary business deductions, special deductions are allowed in computing a life insurance company's gain from operations. The combined deductions for policyholder dividends, certain amounts attributable to nonparticipating contracts, and to accident and health and group life insurance contracts, are subject to a special limitation. Under the limitation, these deductions cannot exceed $250,000 plus the amount by which gain from operations (computed without regard to these deductions) exceeds taxable investment income.

Reasons for Change

The committee believes that the policyholder dividend deduction limitation should be revised to carry out Congressional intent that investment income attributable to insured pension plans would be tax-free and permit the insurance industry to compete effectively for qualified pension plan business.

Further, the committee believes that the level at which policyholder dividends are deductible should generally be increased for a stop-gap period pending a complete review of this area of the tax law.

Finally, the committee believes that the minimum dollar limitation on deductible amounts should be increased during a three year stop-gap period to reflect the effects of inflation since the existing amount was enacted in 1959, and restore the assistance originally intended for small companies. The committee also believes that the benefits of the minimum dollar limitation should be targeted toward small companies.

Explanation of Provisions

For a three-year stop-gap period, there would be two alternative means of calculating the limitation for the policyholder dividend deduction and other special deductions.

In general, the first alternative would revise the present limitation by increasing the statutory dollar limit from $250,000 to $1 million.

The second alternative would generally provide a limitation determined as the sum of:

(a) 100 percent of the dividends attributable to insured qualified pension plans;

(b) a statutory amount of $1,000,000 (same as in the first alternative); and

(c) in the case of a mutual company, 77½ percent of the amount of policyholder dividends or, in the case of a stock company, 85 percent of the sum of policyholder dividends and the special deduction for nonparticipating contracts.

The bill revises the manner in which the statutory dollar amount applies to an affiliated group of corporations. In the case of an affiliated group, the dollar limit is to be divided equally among the companies which are component members of the group on December 31 of each taxable year unless Treasury regulations are prescribed to permit an unequal allocation.

The benefits from the statutory dollar amount will be targeted toward smaller companies. The dollar limit will be phased down when the sum of the policyholder dividends and the special deduction amounts (amounts attributable to nonparticipating contracts otherwise allowable under section 809(d)(5) and to accident and health and group life insurance contracts otherwise allowable under section 809(d)(6)) exceeds $4 million. The dollar limitation would be totally eliminated when the sum of the policyholder dividends and special deductions equals or exceeds $8 million. At this "large company" level, the limitation applicable to nonqualified business would be determined solely under the percentage limitation provisions.

With respect to the percentage limitations of 77½ percent for mutual companies and 85 percent for stock companies, the 7½ percent differential is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company), and accordingly, should not be deductible.

The alternative limitation is determined by applying the applicable percentage to a "base amount". For this purpose, the "base amount" is defined as the excess of the sum of the amounts otherwise deductible as policyholder dividends (Code section 809(d)(3)) and as the special deduction for nonparticipating contracts (Code section 809(d)(5))[4] over the fully deductible dividends allocable to qualified pension plans. The limitation applies first to policyholder dividends, then to the special deduction for nonparticipating contracts, and finally to the special accident and health and group life insurance deduction.

Effective Date

The provisions are effective for a temporary three-year stop-gap period and apply to taxable years beginning after December 31, 1981, and before January 1, 1985.

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[4] Although the special 2 percent of premiums deduction for accident and health and group life insurance (Code sec. 809(d)(6)) is subject to the limitation, those amounts are not taken into account in computing the base amount. This treatment essentially preserves the nondeductible treatment for these amounts that has existed since 1959 and protects against substantial revenue losses which would otherwise occur.

3. Life insurance reserves (secs. 262 and 265 of the bill and sec. 818 of the Code)

Present Law

The concept of reserves is taken into account for several purposes under the life insurance company tax rules. The concept of life insurance reserves is relevant to the definition of a life insurance company which is subject to the special tax provisions; the concept of adjusted life insurance reserves is taken into account for purposes of determining the policyholders' share of investment yield which is excludable from taxable investment income; and increases and decreases in life insurance and other reserves are taken into account in determining gain or loss from operations.

Present law (Code section 818(c)(2)) permits taxpayers to revalue life insurance reserves computed on a preliminary term basis to a net level premium basis. This revaluation may be done under either an exact revaluation method or an approximate revaluation method. Under the approximate revaluation method, reserves are generally increased by $21 per $1,000 insurance in force (other than term insurance) less 2.1 percent of reserves under such contracts. Reserves for term insurance are increased by $5 per $1,000 term insurance in force covering a period of more than 15 years, less 0.5 percent of reserves under such contracts.

Under present law, certain taxpayers have calculated reserves for certain deferred annuities and similar contracts (including certain tax-qualified pension contracts) in a manner that accelerates deductions for interest in excess of the assumed rate that is guaranteed for longer than one year. In general, the reserve is computed by taking the interest guaranteed for future periods into account at the guaranteed rate but is discounted to present value at the end of the company's taxable year at the low rate required to be assumed by State regulatory authorities (typically at a rate of approximately 4 percent). The effect of computing reserves in this manner is to accelerate deductions in computing gain from operations for interest payable in subsequent taxable years. This computation also increases the reserves for purposes of computing the portion of investment yield excludable from taxable investment income.

Reasons for Change

The committee believes that the approximate method for revaluing reserves for life insurance other than term insurance on a preliminary term basis ($21 per $1,000 insurance in force) should be revised because it produces reserves greater than what is actuarially needed. This is due to changed circumstances since 1959 (e.g., mortality, product and reserve method changes) and because many large established companies have obtained excessive allowances by electing the method which was originally intended to aid new and small companies by providing an administratively simple method of recalculating reserves.

The committee also believes that it is appropriate to prevent companies from obtaining an accelerated deduction for interest, in excess of the assumed rate, that is guaranteed for periods after the close of a taxable year. Moreover, the committee believes that restrictions are required to preclude excessively generous treatment for annuity contracts and qualified pension contracts since the bill also permits a 100 percent deduction for interest credited on annuity contracts and for policyholder dividends credited to qualified pension contracts.

Explanation of Provisions

The bill reduces the amount by which reserves computed on a preliminary term basis may be increased for insurance other than term insurance under the approximate revaluation formula (Code sec. 818(c)(2)). For that insurance, reserves would be increased by $19 per $1,000 insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 insurance in force and reduced by 2.1 percent under present law).

The bill will permit taxpayers to switch from the approximate revaluation method to the exact revaluation method without obtaining the consent of the Internal Revenue Service. A taxpayer may adopt the exact revaluation method for its first taxable year beginning after 1981.

The committee has been informed that some policies which are in substance renewable term policies eligible only for, at most, the $5 per thousand approximate revaluation adjustment have been labeled "whole life" policies so that the issuing company may claim the higher revaluation adjustment for insurance other than term insurance.[5] For example, in certain cases, these disguised term policies have not provided a cash surrender value until the contract has been in force for 16 years or longer, or have provided for the payment of premiums commensurate with a whole life insurance policy only when the insured is 80 years old. While the committee recognizes that certain graded premium policies may be appropriately treated as whole life policies, the committee is concerned that many graded premium policies are not entitled to the reserve deductions claimed by the issuing companies. It is the committee's understanding that whole life policies eligible for the $19 per thousand reserve revaluation adjustment should either have a substantial cash surrender value within several years after the policy is issued or level premiums should be charged within a relatively short period of time after the policy is issued. The committee expects the Treasury Department to issue regulations dealing with this matter.

With respect to interest guaranteed under a contract, the bill provides that, in computing reserves with respect to the contract, the interest guaranteed for periods beyond the end of the taxable year is not to be taken into account to the extent attributable to an interest rate exceeding the rate assumed in computing statutory reserves.

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[5] Report to the Congress by the Comptroller General, "Billions of Dollars Are Involved in Taxation of the Life Insurance Industry—Some Corrections in the Law Are Needed," p. 65 (Report No. PAD-81-1, Sept. 17, 1981).

Effective Dates

The provision relating to the approximate revaluation formula is effective for contracts entered into after March 31, 1982 for taxable years beginning after December 31, 1981, and before January 1, 1985.

The provision relating to the computation of reserves for guaranteed interest applies to guarantees made after July 1, 1982 and before January 1, 1985, for taxable year beginning after December 31, 1981 and before January 1, 1985.

4. Menge formula (secs. 263 and 265 of the bill and sec. 805(c) of the Code)

Present Law

Under present law, a formula, commonly called the "Menge" formula, is used to compute the amount of adjusted life insurance reserves. Simply stated, the "Menge" formula is a mechanical arithmetic adjustment used to compute adjusted life insurance reserves. This computation is then used in determining the policyholders' share of investment yield and accordingly affects the computation of a life insurance company's taxable investment income.

The formula operates to reduce life insurance reserves (other than pension reserves) by 10 percent for each percentage point by which the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves.

Reasons for Change

The committee believes that, for the three-year stopgap period for temporary corrections in the law, the inaccuracies in the operation of the "Menge" formula which are attributable to substantial increases in interest rates should be corrected.

Explanation of Provision

For a 3-year stopgap period, the 10-for-1 "Menge" formula will be revised to allow the policyholders' share of investment yield to be computed by using a geometric 10-for-1 formula to adjust statutory life reserves.

Effective Date

The provision applies to taxable years beginning after December 31, 1981, and before January 1, 1985.

5. Consolidated returns (secs. 264 and 265 of the bill and sec. 818 of the Code)

Present Law

Under present law, two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies. For reporting purposes, some taxpayers have taken the position that taxable income first is determined for each component member of the affiliated group (e.g., taxable investment income for some companies and gain from operations for others) and then consolidated by adding those separate company taxable income bases. This approach is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as taken in letter rulings, has been that the taxable investment income bases and the gain from operations bases first must be aggregated to arrive at consolidated group amounts and then these aggregate tax bases (taxable investment income and gain from operations) would apply for the consolidated group. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed on June 3, 1982, with respect to consolidation of non-life and life companies, a modified phase-by-phase method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the limitation on policyholder dividends and special deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return is after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Internal Revenue Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

Reasons for Change

The committee believes that "bottom line" consolidated reporting should be permitted during the three-year stopgap period during which time a thorough Congressional review of this complicated area of the tax law can be conducted. In addition, the Committee believes that prior reporting practices should be protected against any possible retroactive effect under revised Treasury regulations.

Explanation of Provision

For a 3-year stopgap period, the bill provides that consolidated life insurance company taxable income will be determined by first computing the separate life insurance company taxable income for each affiliated company and then combining those amounts. This provision applies to the consolidation of affiliated domestic life insurance companies and to a life insurance subgroup within an affiliated group. Also, grandfathering protection is provided for companies that have taken this reporting position for taxable years beginning before 1982. Under this provision, the Internal Revenue Service cannot disturb a bottom-line reporting position taken in a consolidated return, including an amended return, filed before July 1, 1982.

The provisions will not affect the treatment of items computed on a consolidated basis which are not unique to life insurance companies, e.g., items such as charitable deductions would be subject to the general consolidated return rules applicable to all taxpayers.

Effective Date

The stopgap provision applies to taxable years beginning after December 31, 1981, and before January 1, 1985. The grandfather protection applies to taxable years beginning before 1982 for returns filed before July 1, 1982.

6. Full deduction for amounts credited to annuity contracts (sec. 266 of the bill and secs. 805 and 809 of the Code)

Present Law

Under present law, the share of each and every item of investment yield of life insurance company that is set aside for policyholders is not included in computing taxable investment income or the gain or loss from operations (Code secs. 805(a) and 809(a)). For purposes of computing gain or loss from operations, the share of any item set aside for policyholders is the percentage obtained by dividing the "required interest" by the investment yield. The required interest is the sum of the amounts determined by multiplying the required or assumed rates of interest used by the company in calculating reserves for State insurance law purposes by the mean of the applicable reserve at the beginning and end of the taxable year.[6] No interest in excess of the assumed rate of interest may enter into this calculation.

For purposes of determining gain or loss from operations, a deduction is allowed for all claims and benefits accrued, and all losses incurred during the taxable year on insurance and annuity contracts. Likewise, a special deduction is allowed for policyholder dividends (sec. 809(d)(3)). This deduction, however, is limited to $250,000 plus the excess of gain from operations (computed without regard to special deductions) over taxable investment income.

In certain deferred annuity contracts, life insurance companies have credited interest at rates in excess of the relatively low rate that is assumed in their contracts for State law purposes. This "excess interest" is typically credited at a rate that is guaranteed, in advance, for a temporary future period. In computing their taxable income, these companies have fully deducted the credited excess interest as additions to reserves to provide for benefits guaranteed under the contract.

Recently, the Internal Revenue Service took the position (Rev. Rul. 82-133) that the excess interest credited with respect to certain deferred annuity contracts is a policyholder dividend subject to the statutory deduction limitation.

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[6] Six kinds of reserves are taken into account in computing required interest: (1) life insurance reserves; (2) unearned premiums and unpaid losses (not included in life insurance reserves); (3) amounts necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (when the computation is made) life, health or accident contingencies; (4) dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) special contingency reserves under contracts of group term life insurance or group health and accident insurance.

Reasons for Change

The committee believes that, in light of the changes that will be made by the bill to the tax treatment of deferred annuity policyholders, it is appropriate to allow a full deduction to the issuing company for all amounts credited to these contracts.

In addition, the committee is concerned that the practical effect of the Service's position may be to eliminate or substantially curtail the marketing of these products, resulting in a cessation or significant reduction of business on the part of some companies. Consequently, the committee believes it is appropriate to resolve the legal uncertainty in this area with legislation.

Explanation of Provision

For purposes of computing taxable investment income, the committee bill provides that amounts of qualified guaranteed interest paid or credited with respect to certain annuity contracts will be taken into account as interest paid for purposes of determining policy and other contract liabilities (Code sec. 805 (a)(3) and (e)). This results in treating the portion of the investment yield allocable to those amounts as excludable from taxable investment income (Code sec. 804(a)(1)). Also, for purposes of determining gain or loss from operations, a similar treatment is prescribed by treating amounts of qualified guaranteed interest as required interest (Code sec. 809(a)(2)).

For these purposes, qualified guaranteed interest will include all amounts in the nature of interest determined (1) under a rate guaranteed in advance for not less than 12 months, or (2) under any formula or other method (including an "index") guaranteed in advance for not less than 12 months, if the terms of the formula are beyond the control of the company and are independent of the experience of the company. Under a special transition rule, existing contracts failing to qualify because the guarantee is for less than 12 months may be conformed by January 1, 1983, and retroactively qualified for purposes of these requirements.

Qualified guaranteed interest will only be allowed for annuity contracts which involve (at the time the interest is credited) life contingencies, which are nonparticipating, and which provide that excess interest may be credited thereunder. Contracts used to fund tax-exempt qualified employee or retirement plans (described in section 805(d)) are not treated as qualified contracts for purposes of these provisions since policyholder dividends under such contracts are fully deductible under the bill's new dividend limitation formula and are presently eligible for favorable investment yield allocation rules based on current earnings rates (Code sec. 805(a)(2)). Also, the provisions do not apply to variable annuity contracts with reserves based on segregated asset accounts (Code sec. 801(g)). Finally, the provisions are not intended in any way to resolve issues under present law as to the proper classification of so-called "wraparound" annuities.

Since, for purposes of computing taxable investment income, the qualified guaranteed interest will be taken into account separately for allocating the excludable policyholders share of investment yield, conforming changes are made to exclude the contractual policy interest and related reserves from other computations relating to this allocation (i.e., the determination of adjusted life insurance reserves (Code sec. 805(c) and the operation of the Menge formula). Thus, in computing taxable investment income, no double exclusion is allowed with respect to the assumed rate portion of the qualified guaranteed interest (i.e., no amount will be excluded to the extent it is attributable to the interest assumed under section 805(a)(1), because it is taken into account as interest paid under section 805(e)).

Finally, the bill provides that qualified guaranteed interest is included in "required interest" (Code sec. 809(a)(2)) for purposes of computing gain or loss from operations. Again, to avoid a double exclusion for the assumed interest portion of the qualified guaranteed interest, reserves on these contracts are excluded from the reserves that are multiplied by their assumed rates to produce a portion of the required interest. Since qualified guaranteed interest is already taken into account in required interest, no part of such interest can be included in computing either the deduction for an increase in reserves (Code sec. 809(d)(2)), or the income item from a decrease in reserves (Code sec. 809(c)(2)), or as an interest paid deduction (sec. 809 (d)(11) and (e)).

Effective Date

These provisions apply for taxable years beginning after December 31, 1981.

7. Tax treatment of deferred annuities (sec. 267 of the bill and sec. 72 of the Code)

Present Law

A commercial annuity contract is a promise by a life insurance company to pay to the beneficiary a given sum for a specified period, which period may terminate at death.[7] Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income. The insurance company may take the risk that such amount will be exhausted before the company's liability under the contract ends but may gain if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period."

An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

Present law provides that taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn (secs. 72 (a) and (e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an "exclusion ratio" (sec. 72(b)) computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment. Policy dividends paid after annuity payments begin are not subject to the "exclusion ratio", but are taxable in full to the policyholder as ordinary income. Amounts paid out under a contract before the annuity payments begin, such as payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)).

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[7] If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is called a "variable annuity contract."

Reasons for Change

Traditionally, annuity contracts have been viewed as safe, conservative, but low-yielding investments purchased by individuals who wish both to provide for income during their retirement and to insure against the possibility of outliving their assets. Deferred annuities typically guaranteed and limited both the rate of interest at which the principal would grow during the accumulation period and the rate at which that amount could be converted to annuity payments at the end of that period. Although taxes were deferred during the accumulation period, the relatively low yields and high commissions made deferred annuities less attractive for short-term investment by comparison with other investment alternatives.

In recent years, however, the life insurance industry has developed new products that provide an investment yield for the policyholder that is competitive with other commercial investments that do not enjoy the same tax treatment. By emphasizing the benefits of tax deferral during the accumulation period, the tax-favored treatment of partial surrenders, and options for lump sum settlements, deferred annuities have been actively marketed as tax shelters. Although the current tax rules were enacted when deferred annuities were used to provide long-term income security, variations on traditional products have been developed that are comparable to short-term money market investments.

The committee believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal. However, the committee believes that their use for short-term investment and income tax deferral should be discouraged.

Explanation of Provision

The committee bill makes two changes to the present tax treatment of annuity contracts. First, the bill provides that partial surrenders or cash withdrawals prior to the annuity starting date will be treated as income, to the extent that the cash value of the contract exceeds the investment in the contract. To the extent the cash value does not exceed the investment in the contract, such withdrawals will be treated as return of principal to the policyholder. A withdrawal during any policy year will only be treated as such to the extent it exceeds the premiums paid during the year and after the withdrawal was made. The Committee anticipates that transitory deposits of premiums (for example, payment of a premium late in December followed by a withdrawal in early January) will be disregarded for purposes of measuring net withdrawals during a year. For purposes of this new rule, loans against a contract or pledging an annuity contract will be treated the same as a cash withdrawal.

Second, the bill imposes a penalty if a policyholder makes a withdrawal prior to the annuity starting date or receives any amount under the contract within 10 years of making an investment in the contract. The amount of the penalty will be 10 percent of the amount that is allocable to an investment made within the last ten years and includible in income by the policyholder. For this purpose, an amount includible in income will be allocable to the most recent investment first. This penalty will not be imposed if the amount is not received before the policyholder reaches age 59½, or is one of a series of substantially equal periodic payments made for life or for a period of at least 120 months. In addition, the penalty will not be imposed if the withdrawal follows the death of the policyholder or is attributable to the policyholder becoming disabled.

The bill does not change the tax treatment of withdrawals from most life insurance and endowment contracts. However, the Secretary is authorized to issue regulatory guidelines as to when the amount at risk under these types of contracts is sufficiently minimal that the contract should be treated as an annuity for purposes of these provisions. Also, the revised rules will not apply to tax-qualified employee pension and retirement plans.

Effective Date

The provisions apply to amounts allocable to investments made to annuity contracts after July 1, 1982. The 10 percent penalty will apply only to amounts withdrawn after December 31, 1982.

8. Flexible premium life insurance contracts (sec. 268 of the bill and sec. 101 of the Code)

Present Law

Present law provides that gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if the amounts are paid by reason of the death of the insured (sec. 101(a)).

In addition, prior to the death of the insured, amounts credited to the cash value of a life insurance contract are taxed only when withdrawn and to the extent the withdrawals exceed the aggregate premiums paid by the policyholder for the contract (sec. 72(e)).

In recent years, life insurance companies have been marketing flexible premium life insurance contracts (referred to as "universal life" or "adjustable life"). These contracts are similar in some respects to traditional whole life policies, but typically permit the policyholder to change the amount and timing of the premiums and the size of the death benefit automatically as the policyholder's needs change. These contracts may permit the policyholder to invest a substantial cash fund without a related increase in the amount of pure insurance protection offered by the contracts.

In a letter ruling (January 23, 1981), the Internal Revenue Service concluded that the entire amount paid upon the death of the insured under such a flexible premium insurance contract is excluded from gross income as proceeds of a life insurance contract under section 101(a), even though the death benefit may reflect a large cash fund and a relatively small amount of pure insurance protection. If the contract is treated as a life insurance contract, the interest on the cash fund is not subject to tax, unless the contract is surrendered prior to the death of the insured. Subsequent to the letter ruling, the Service announced that it was reconsidering its position on flexible premium life insurance contracts. Thus, it is unclear whether such contracts will be treated as life insurance contracts for tax purposes.

Reasons for Change

The committee believes that flexible premium life insurance contracts should have the same tax treatment as traditional level-premium whole life insurance contracts if they are substantially comparable to traditional contracts. However, the committee is concerned by the fact that some flexible premium contracts can be overly investment oriented by allowing large cash value build-ups without requiring a continued reasonable amount of pure insurance protection.

Because the uncertain tax treatment of flexible premium life insurance contracts has caused significant confusion among consumers and life insurance companies, the committee believes that it is appropriate to resolve the tax treatment of these contracts by legislation.

Explanation of Provisions

The bill provides guidelines that flexible premium life insurance contracts must meet in order to be treated as life insurance for tax purposes. If these guidelines are violated at any time over the duration of the contract, the contract will not be treated as providing life insurance for tax purposes.

A flexible premium life insurance contract is a life insurance contract which provides for the payment of one or more premiums that are not fixed by the company as to timing and amount. The term flexible premium life insurance contract also includes contracts with riders for family term life insurance (e.g., for the insured, a spouse or a child), for an accidental death benefit, for a waiver of premium benefit, and for a guaranteed insurability benefit. The term does not include contracts with annuity benefits other than those provided as settlement options.

To be treated as a life insurance contract for tax purposes, a flexible premium contract must meet the following tests: (1) the sum of the premiums paid under the contract at any time cannot exceed a specifically computed guideline premium limitation; and (2) the amounts payable on the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death. For purposes of applying the first test, the sum of the premiums paid includes premiums for any additional benefit riders as well as the primary death benefit. However, this amount should be reduced by any amounts received by the policyholder and not includible in income under section 72(e).

The first test will not apply with respect to a premium payment that would cause the sum of the premiums to exceed the guideline premium limitation to the extent that the premium payment is necessary to prevent termination of the contract on or before the end of the contract year. Also, if it is established to the satisfaction of the Secretary that the first test was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the first test. If a premium that would cause the first test to be violated is returned (together with interest allocable thereto) within 30 days after the end of any policy year, the first test will be deemed to have been satisfied. The interest returned with such a premium will be includible in the policyholder's income currently notwithstanding the general rules of section 72(e).

The use of premium limitation in the first test is intended to prevent investment motivated contributions of large cash amounts to the contract. The guideline premium limitation means, on any date, the greater of: (1) the single premium at issue necessary to fund the future benefits provided under the contract, based on mortality and other charges fixed in the contract and interest at the greater of 6 percent or the rate guaranteed in the contract; or (2) the sum of the level annual amounts (payable over the life of the contract, but not less than 20 years), computed on the same basis as the single premium except that the interest rate used cannot be less than 4 percent. For purposes of computing the guideline premium, benefits provided under additional benefit riders should not be taken into account.

The bill also contains three computational rules for the guideline premiums, which are designed to limit the range of future benefits that may be assumed in computing such premiums. First, the net amount at risk assumed to exist at any time in the future of the contract cannot exceed the comparable amount existing when the contract is issued. Absent such a rule, the guideline premiums could be artificially raised by assuming increased future death benefits even though there is no intention to keep the contract in force until those benefits are actually effective. For purposes of this rule, the cash value of the contract (one of the factors that determines the net amount at risk) would be the cash value accumulated by using the same assumptions concerning interest rates, mortality charges, and other charges used to compute the guideline premiums. Second, the maturity date of the contract is the latest date permitted under the contract, which cannot be less than 20 years after the contract is issued or age 95, if earlier. Third, the amount of any endowment benefit (*i.e.*, the benefit payable if the insured survives to the contract's maturity date) cannot exceed the smallest death benefit at any time, from the issue date to the maturity date, that was used as the future contractual benefit assumed in computing the guideline premiums. This rule is designed to require that guideline premiums be computed on a basis consistent with the premium computation for a traditional endowment policy, where the endowment benefit generally equals the death benefit.

At the start of the contract the guideline premiums are based on the future benefits specified in the contract as of such date. If future contract benefits are changed at a subsequent date, the guideline premiums will be adjusted (upward or downward) to reflect the change. Such adjustments should not be made for increases in the death benefit that reflect excess interest that has been credited.

Finally, the restriction on the death benefit in the second test is intended to ensure that flexible premium contracts will offer at least a minimum amount of pure insurance protection at all times. For purposes of meeting the second test, the death benefit under a flexible premium contract must be 140 percent of the cash value until the insured reaches age 40; thereafter, the percentage is reduced by one percent for each year until the insured reaches age 76. This sliding scale for the death benefit ensures that the policy provide a reasonable and minimum amount of pure insurance protection at all times.

Effective Dates

The provisions regarding flexible premium life insurance contracts shall apply to all such contracts issued before January 1, 1985.

The bill provides a twelve month grace period from the day of enactment for companies to bring contracts issued before October 1, 1982 into compliance with the new provisions.

9. Grandfathering for treatment of indeterminate premium policies (sec. 265 of the bill and secs. 809(c) and 811 of the Code)[1]

Present Law

In recent years, stock companies have begun to offer "indeterminate premium" policies under which the company charges a premium lower than the maximum premium fixed in the policy. Such lower premiums are charged to the policyholder on a temporary basis (typically for 1 year) because the rate of interest that companies can assume in setting policy benefits is limited as a practical matter by State law. In computing taxable income, companies have taken the reporting position that only the payments that are actually received under the indeterminate premium policies are included in gross income.

In a widely publicized private letter ruling, issued in June, 1982, the IRS held, among other things, that the excess of the maximum premium chargeable over the premium actually collected should be treated as a distribution of policyholder dividends which is paid back as a premium to the company.

Reasons for Change

The committee believes that it is appropriate to provide grandfathering protection against audit reclassification of prior reporting practices for indeterminate premium policies.

Explanation of Provision

For taxable years beginning before 1982, the bill provides that amounts that could have been charged as a premium or mortality charge, but were not, are not to be included in premium income (Code sec. 809(c)(1)).

No inference is to be drawn as to the treatment of these premiums for taxable years beginning after 1981 as a result of the provision.

Effective Date

The provision is effective for taxable years beginning before 1982.

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[1] Grandfathering rules relating to the treatment of excess interest, modified coinsurance contracts, and consolidated return reporting positions are described under the related description of the permanent or stopgap provisions.

10. Underpayments of 1982 estimated taxes (sec. 269 of the bill and sec. 6655 of the Code)

Present Law

Under present law, a corporation generally must make payments of its estimated tax liability for the taxable year. The estimated tax is payable in up to four installments over the taxable year.

In general, if estimated tax payments are not equal to at least 80 percent of the tax due, a nondeductible penalty equal to the interest that would accrue on the unpaid tax is imposed on the amount of the underpayment for the period of underpayment. However, the underpayment penalty does not apply if, before the due date of any installment, the corporation pays an installment based on:

(1) the corporation's tax liability for the prior year,

(2) the corporation's tax liability on the prior year's income computed using tax rates for the current year, or

(3) 80 percent of the tax which would be due if the corporation's annual income were equal to the amount which would result if the corporation continued to receive income during the remainder of the year at the same rate experienced up to the date of the installment (i.e., the corporation's income computed on an annualized basis).

Reasons for Change

Several provisions under the bill will increase the 1982 tax liabilities of life insurance companies because those provisions are effective in 1982. For example, the repeal of the modified coinsurance provisions applies as of January 1, 1982, and the reduction in the formula used to revalue reserves computed on a preliminary term basis applies after March 31, 1982. Because these changes would not be taken into account for 1982 estimated tax installments due before the changes are actually enacted, the committee believes that the underpayment penalty that would otherwise apply to those installments should be waived to the extent tax increases are attributable to legislative changes.

Explanation of Provision

The bill provides that the addition to tax for failure to pay the corporate estimated tax shall be waived for any underpayment period ending before September 15, 1982, to the extent the underpayment was created or increased by the provisions of the bill. If the underpayment is not paid on or before the date prescribed for the third installment (September 15, 1982 for calendar year taxpayers under sec. 6154(b)), the underpayment period for the prior installments eligible for the waiver will, in effect, commence on September 15, 1982, for purposes of present law (sec. 6655(c)).

Effective Date

The provision is effective on the date of enactment of the Act for underpayment periods occurring prior to December 15, 1982.

11. Revenue effects

It is estimated that the provisions relating to the taxation of life insurance companies and annuities will increase budget receipts by $489 million in fiscal year 1982, $1,487 million in 1983, $1,510 million in 1984, $2,183 million in 1985, $2,935 million in 1986, and $3,167 million in 1987.

F. Employment Tax Provisions

1. Independent Contractor Provisions[*]

a. Alternative standards for determining classification of workers for employment purposes and extension of interim relief provision (secs. 271 and 274 of the bill and new sec. 3508 of the Code)

Present Law

Classification of workers

Overview

Under present law, common law (i.e., nonstatutory) rules generally apply to determine whether particular workers are treated as employees or as independent contractors (self-employed persons) for purposes of Federal employment taxes.[1]

Under the common law test, an employer-employee relationship generally "exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[2] Thus, the most important factor under the common law is the degree of control, or right of control, which the employer has over the manner in which the worker is to perform services for the employer. Generally, "physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession in which they offer their services to the public" are not common law employees (Reg. §31.3401(c)–1(c)).

The determination of whether an employer-employee relationship exists is important because wages paid to employees generally are subject to social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and to unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). Compensation paid to independent contractors is subject to the tax on self-employment income (SECA), but not to FICA or FUTA taxes. The SECA tax is paid only by the self-employed individual. In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

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[*] The independent contractor provisions relating to information reporting and penalties are included in section C., "Provisions Designed To Improve Taxpayer Compliance."

[1] Code secs. 3121(d)(2) (FICA), 3306(i) (FUTA), and 1402(d) (SECA). However, sec. 3121(d)(3) (relating to statutory emloyees under the Federal Insurance Contributions Act) establishes four categories of statutory employees: certain agent-drivers or commission-drivers; full-time life insurance salespersons; home workers performing services on goods or materials; and full-time traveling or city salespersons. See also secs. 3306(i) and 1402(d).

[2] See Reg. § 31.3401(c)–1(b).

Consideration of various factors

In determining whether the necessary degree of control exists in order to find that an individual has common law employee status, the courts and the Internal Revenue Service ordinarily consider a number of factors. No single factor generally is dispositive of the issue. Instead, all of the facts of a particular situation must be evaluated and weighed in light of the presence or absence of the various pertinent characteristics. The decision as to the weight to be accorded to any single factor necessarily depends upon both the activity under consideration and the purpose underlying the use of the factor as an element of the classification decision. Because of the particular attributes of a specific occupation, any single factor may be inapplicable.

List of factors

The 20 common law factors[3] generally considered in determining whether an employer-employee relationship exists are directed at the following questions:

1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?
2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?
3. Are the services performed by the individual integrated into the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?
6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship?
7. Who sets the hours of work?
8. Is the individual required to devote full time to the person for whom he or she performs services?
9. Does the individual perform work on another's business premises?
10. Who directs the order or sequence in which the work must be done?
11. Are regular oral or written reports required?
12. What is the method of payment—hourly, weekly, commission, or by the job?
13. Are business or traveling expenses reimbursed?
14. Who furnishes tools and materials necessary for the provision of services?
15. Does the individual performing services have a significant investment in facilities used to perform services?

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[3] The common law factors are set forth in the following Internal Revenue Service documents: Exhibit 4640-1, Internal Revenue Manual 8463 and Chapter 2, "Employer-Employee Relationships," Training 3142-01 (Rev. 5-71).

16. Can the individual providing services realize both a profit or loss?

17. Can the individual providing services work for a number of firms at the same time?

18. Does the individual make his or her services available to the general public?

19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?

20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

Effect of classification on tax liabilities

Employees

FICA tax

The Federal Insurance Contributions Act (Code secs. 3101–3126) imposes two taxes on employers and two taxes on employees. These taxes are used to finance the payment of old-age, survivors, and disability insurance benefits payable under Title II of the Social Security Act and to finance the costs of hospital and related post-hospital services incurred by social security beneficiaries as provided in Part A of Title XVIII of the Social Security Act (Medicare).

The FICA tax base is measured by the amount of wages received with respect to employment. The term "wages" generally means all remuneration for employment unless specifically excepted (Reg. § 31.3121(a)-1). The term "employment" includes all nonexempt service, of whatever nature, performed by an employee for the person employing him or her (Reg. § 31.3121(b)-3). An employer must withhold the employee's share of FICA taxes from the employee's wages when paid (secs. 3102 (a) and (b)).

For calendar year 1982, employers and employees are each required to pay FICA tax of 6.70 percent on the first $32,400 of an employee's wages (for a maximum of $2,170.80 each, or a total maximum of $4,341.60 per employee).[4]

FUTA tax

The Federal Unemployment Tax Act (Code secs 3301–3311) imposes a tax on employers. FUTA tax revenues are used to pay the administrative costs of Federal and State unemployment compensation programs and to help finance the payment of benefits to unemployed insured workers.

The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages of up to $6,000 a year paid to an employee (sec. 3301). However, a 2.7 percent credit against Federal tax liability normally is provided to employers who pay State taxes under an approved State unemployment compensation program (sec. 3302). For employers in States which have an approved unemployment compensation program, the effective FUTA tax rate normally is 0.7 percent (a maximum of $42 per employee).[5]

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[4] The current FICA tax rate is scheduled to increase to 7.05 percent in 1985, 7.15 percent in 1986, and 7.65 percent in 1990.

The FUTA tax generally applies to an employer who employs one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pays wages of $1,500 or more during any calendar quarter of the current or preceding calendar year. In addition, certain agricultural labor and domestic services constitute covered employment for purposes of the FUTA tax.

Income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to individual employees must withhold and pay over amounts for the employee's Federal income tax liability (sec. 3402).

The definitions relating to employment for purposes of income tax withholding are similar to the FICA and FUTA definitions. The term "employer" generally is defined as any person for whom an individual performs any service as an employee. An "employee" is an individual who performs services subject to the control of an employer, both as to what shall be done and how (Reg. § 31.3401(c)-1). The term "wages" is defined generally as all remuneration, unless specifically excluded, for services performed by an employee for the employer, including the cash value of all remuneration paid other than in cash (sec. 3401(a)).

Self-employed individuals

SECA tax

The Self-Employment Contributions Act (Code secs. 1401-1403) imposes two taxes on the self-employed. The SECA tax finances the cost of old-age, survivors, and disability insurance benefits payable under Title II of the Social Security Act, as well as the cost of hospital and related post-hospital services incurred by social security beneficiaries (as provided for in Part A of Title XVIII of the Social Security Act).

The taxes levied under SECA, and the amount of income which may be credited toward benefits or insurance coverage, are based on an individual's self-employment income. The term "net earnings from self-employment" generally means the sum of: (1) the gross income derived by an individual from any trade or business carried on by such individual, less allowable deductions attributable to such trade or business, and (2) the individual's distributive share of the ordinary net income or loss from any trade or business carried on by a partnership of which the individual is a member (sec. 1402(a)). The term "self-employment income" excludes net earnings from self-employment in any taxable year if such earnings are less than $400 (sec. 1402(b)).

For calendar year 1982, a self-employed individual must pay SECA tax at a rate of 9.35 percent on net earnings of up to $32,400

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[5] Under section 275 of the bill, effective January 1, 1983, the FUTA wage base is increased to $7,000 and the tax rate is increased to 3.5 percent. Effective January 1, 1985, the FUTA tax rate is increased to 6.2 percent (a permanent tax of 6.0 percent and an extended benefit tax of 0.2 percent), and the credit which employers receive against the tax is increased to 5.4 percent.

(for a maximum SECA tax of $3,029.40).[6] Although the SECA tax rate (9.35 percent) is higher than the rate applicable to an employee's share of FICA tax (6.70 percent), it is lower than the combined employer-employee FICA rate (13.4 percent). An individual with $400 or more of net earnings from self-employment for the year must file a return showing the self-employment tax due (sec. 6017).

Income tax withholding

There is no Federal income tax withholding with respect to self-employment income. A self-employed individual may be required to file a declaration of estimated income tax if his or her gross income for the year reasonably can be expected to include more than $500 from sources other than wages (sec. 6015). However, no declaration is required if the amount of estimated tax for the year is less than $200.[7]

Interim relief relating to classification controversies

In general

Section 530 of the Revenue Act of 1978 provided interim relief to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service. That provision terminated employment tax liabilities for periods ending before 1979; allowed taxpayers who had a reasonable basis for not treating workers as employees in the past to continue such treatment for periods ending before 1980; and prohibited the issuance, prior to 1980, of regulations and revenue rulings on common law employment status.

These temporary prohibitions were extended through December 31, 1980, by P.L. 96-167, and then through June 30, 1982, by Public Law 96-541.

Classification standards

Section 530 of the 1978 Act established three alternative statutory standards that, if met, provided a reasonable basis for treating a worker as an independent contractor. The first standard was met if the taxpayer's treatment of a worker was due to reasonable reliance upon judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling issued to the taxpayer. The second standard could be met by showing reasonable reliance upon a past Internal Revenue Service audit of the taxpayer. The third statutory standard could be met by showing that the treatment of a worker as an independent contractor coincided with a long-standing, recognized practice of a significant segment of the industry in which the worker whose status was at issue was engaged. These three standards for showing a reasonable basis for treating a worker as an independent contractor were not exclusive. That is, a taxpayer could have demonstrated a reasonable basis for treating a worker as an independent contractor in some other manner.

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[6] The SECA tax rate currently is scheduled to increase to a rate of 9.90 percent in 1985, 10 percent in 1986, and 10.75 percent in 1990.

[7] The estimated tax payment threshold is scheduled to increase in annual increments of $100 until it reaches $500 for 1985 and subsequent years.

In addition to demonstrating a reasonable basis for treating workers as independent contractors, a taxpayer seeking relief must have filed all Federal tax returns that were required to be filed with respect to workers whose status was at issue on a basis consistent with the taxpayer's treatment of the workers as independent contractors.

Reasons for Change

During the late 1960s, and continuing into the 1970s, the Internal Revenue Service increased the number of its employment tax audits. As a result of these increased audits, controversies developed between the Internal Revenue Service and some businesses concerning the proper classification of workers.

The interim relief provisions of the Revenue Act of 1978 were intended to provide a temporary solution to the problems arising from increased employment tax status controversies. Those provisions were enacted, and subsequently extended, to afford the Congress adequate time to adopt a permanent solution to the complex issues involved in this area of the tax law.

The committee has determined that the classification of certain types of work relationships should be clarified, both for businesses in seeking to comply with tax liability and reporting requirements and for the Internal Revenue Service in carrying out its responsibilities to enforce those requirements. The committee has concluded that a statutory "safe-harbor" test for determining, in applicable instances, whether an individual should be classified as an employee or an independent contractor will reduce the number of controversies as to employment tax status classifications, and will provide greater certainty and simplification in this area of the tax law. In addition, the committee believes the formal requirements of the safe-harbor will improve tax compliance on the part of independent contractors qualifying under its provisions.

Under the safe harbor provided in the bill, the status of certain workers as independent contractors is determined by statute. Workers whose status is not determined under the safe-harbor rules still will have their employment tax status determined under the common law rules. However, the number of workers whose status will be determined under the common law rules will be significantly reduced.

In addition to providing a safe harbor, other portions of the bill provide enhanced information reporting requirements and increased penalties for failure to provide information. It is anticipated that those provisions, along with the safe-harbor provisions, will greatly improve tax compliance among independent contractors.

Explanation of Provisions

Safe-harbor test

The bill establishes a safe-harbor test that, if satisfied, results in classification of an individual as an independent contractor for Federal employment tax purposes (other than under the Railroad Retirement Tax Act). (In the case of a worker who satisfies the safe-harbor test but who is classified as an employee for social security tax purposes under a specific statutory provision, the safe harbor applies only for income tax purposes. That is, the worker is not treated as an independent contractor for social security tax purposes.) If all five requirements of the test are met with respect to service performed by an individual, then that service is treated as performed by an individual who is not an employee, and the service-recipient is not treated as an employer with respect to that service. (For purposes of the safe-harbor test, a "service-recipient" is the person for whom the service is performed.)

The failure of a worker to qualify as an independent contractor under the safe-harbor test will not affect his or her classification under the common law rules. Thus, if a worker qualifies as an independent contractor under the common law rules, then the worker will continue to be an independent contractor after enactment of the safe-harbor test even if the worker does not satisfy the safe-harbor requirements. Of course, if the service-recipient wishes to establish the worker's status by reference to the new safe-harbor test rather than by reference to the common law rules, then all five requirements of that test must be satisfied.

The safe-harbor requirements relate to (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of tax responsibilities, and (5) the filing of required returns.

(1) Control of hours worked

The first requirement is met if the worker controls both the aggregate number of hours worked and also substantially all of the scheduling of those hours.

Both parts of this requirement generally will be satisfied if the worker is hired simply to accomplish a particular result, without regard to either the amount of time the worker spends in accomplishing the result, or when the worker personally performs the services.

If a worker is hired for a temporary period, or hired to perform a temporary task that must be performed within a certain amount of time, the "aggregate hours" test will be satisfied if the worker is free to accept or refuse specific temporary jobs as he sees fit and cannot be effectively required by the service-recipient to work on a permanent basis. Of course, in order for the two-part control of hours worked requirement to be met, such a worker must satisfy the requirement that he controls substantially all the scheduling of his hours worked.

In determining whether an individual controls the scheduling of hours worked, limitations on scheduling are to be disregarded to the extent they result from government regulatory requirements, from operating procedures and specifications which have been imposed on the service-recipient by another party pursuant to contract, from coordination (by persons other than the service-recipient or a related person) of the performance of the service with the performance of other services, or from control of access to any premises by the service-recipient provided that the individual controls the scheduling of hours worked during the period during which access is granted.

Under this provision on scheduling limitations, the fact that, for reasons beyond the worker's control, certain work can be performed only between certain hours of the day (for example, because of local noise abatement ordinances applicable to construction work) will not adversely affect a determination of whether a worker controls the scheduling of the hours worked. Likewise, the fact that a contractor requires the subcontractors on a construction project to coordinate the performance of their services on the worksite among themselves is to be disregarded in determining whether the control of hours requirement is met. Similarly, if a general contractor is obligated to comply with contractual specifications, the fact that a subcontractor can be required to adjust the scheduling of his hours to conform to those specifications will be disregarded (for example, the construction specifications may require that electrical wiring work begin after frame work is completed). Furthermore, a worker's participation for an insignificant number of hours in incidental meetings, conferences, or similar activities which the worker is required to attend by the service-recipient will not alone disqualify the worker under this test.

The question of whether a worker meets the control of hours test is to be determined primarily by comparing the extent of the worker's control with the extent of control by the service-recipient.

(2) Place of business

The second requirement is met if no principal place of business of the worker with respect to the service is provided by the service-recipient. (Accordingly, the requirement will be met if the worker does not have any principal place of business with respect to the service.) In addition, the second requirement is met even if the service-recipient furnishes a principal place of business with respect to the service if the worker pays a fair rental to the service-recipient for each such principal place of business furnished by the service-recipient.

A determination of whether a fair rental is paid for a place of business is to be made on the basis of all the pertinent facts and circumstances. It is intended that the requirement of a fair rental may not ordinarily be satisfied by a variable payment tied to a percentage of the worker's sales or other output. To qualify as a fair rental, the rental payment ordinarily must be a fixed amount payable to the service-recipient without regard to the worker's income or productivity.

This test is intended to exclude workers who work principally for one service-recipient on a continuing basis and perform their services on the service-recipient's premises, factors that are indicative of an employment relationship. Accordingly, under a special rule, a place of business provided by the service-recipient is not to be treated as a principal place of business of the worker if substantially all (at least 85 percent of the time spent) of the service is performed elsewhere (other than at another place of business provided by the service-recipient). For example, a real estate agent who is provided by the service-recipient with a desk in an office at which he or she makes and receives telephone calls and performs incidental paper work will not thereby fail to qualify under this test if substantially all of the agent's work is performed in the "field," i.e., away from that office and away from any other place of business provided by the service-recipient. Also, mere storage facilities will not ordinarily constitute a principal place of business.

(3) Investment or income fluctuation

The investment or income fluctuation requirement may be met in either of two ways.

Qualifying investments

First, this requirement is satisfied if the worker has a qualifying investment in tangible assets which are used by him or her in connection with the performance of the service. To qualify, the assets must be of significant value in the performance of the service. In addition, the worker's investment in the assets must be a substantial economic investment in light of the nature and amount of the remuneration received for the service. A worker who performs the service using his or her own truck or tractor generally meets this test. Likewise, a skilled artisan who works with sophisticated tools that he or she owns and brings to the job generally meets this test.

The asset investment test is intended to be met where the worker bears a risk of profit or loss in providing services because of a substantial investment in capital, notwithstanding that he or she may be paid on an hourly basis. The asset investment test does not require any particular method of investment; assets which are financed by, or leased or purchased from, a service-recipient are not per se excluded. However, the test requires that the worker's investment be substantial in light of the nature and amount of the remuneration received by the worker. This requirement is designed to insure that the service-recipient does not eliminate or substantially reduce the economic risk associated with the worker's investment, for example, through side arrangements regarding the compensation the worker will receive.

For purposes of this asset investment test, an investment in a vehicle that is used primarily to transport the individual (and any tools, samples, or similar items) would not be taken into account. However, an investment in a vehicle that is used primarily to perform services (such as a vehicle used to perform the service of transporting other individuals, or delivering goods) as well as any separate portion of a disqualified transportation vehicle used primarily for performing services (such as a welding rig affixed to a pick-up truck) could be taken into account.

Risk of income fluctuations

In the alternative, this third requirement is met if the worker risks income fluctuations because substantially all of the cash or other remuneration for the performance of the service is directly related to sales or other output rather than to the number of hours worked. In general, the test will be met by workers who risk fluctuations in the return on their labor because their remuneration is directly related to their technical or entrepreneurial skills or other factors, other than mere time worked. Remuneration that is directly related to sales generally includes percentage commissions, sales bonus prizes and awards, and bonuses for recruiting new sales personnel.

A worker who is paid on a per-job basis or who is paid to accomplish a particular result (without regard to the number of hours it takes) satisfies this test on the basis of risking income fluctuations because the remuneration is based on output, rather than on the number of hours worked. Other examples of workers who qualify under this test are truckers who are paid on the basis of the distance that goods are hauled and loggers who are paid on the basis of standard quantities of wood cut, hauled, and delivered.

The test is designed to ensure that the substance of the work relationship will govern, rather than its form. Thus, if the worker is nominally paid for output, but is hired to produce uniform output on a repetitive basis (i.e., piecework) the worker does not meet the test because he does not risk income fluctuations, even though he is not paid by the hour. In addition, if the service-recipient provides the worker with tangible assets of substantial value in the performance of the service, loans or advances against commissions, or substantial intangible assistance (such as advertising, leads, or referrals), the relationship should be scrutinized to determine whether the service-recipient is in effect guaranteeing the worker a substantial amount of remuneration on the basis of hours worked.

(4) Written contract and notice of tax responsibilities

The fourth requirement of the safe-harbor test is met if both (a) the individual performs services pursuant to a written contract with the service-recipient (entered into before performance of the service) which expressly provides that the individual will not be treated as an employee for purposes of employment taxes, income tax withholding, and certain employee benefit provisions, and (b) the individual is given written notice (in the contract, or at the time the contract is executed) of his or her tax responsibilities for payment of Federal self-employment and income taxes. Of course, individuals who are statutory employees for purposes of FICA [8] will continue to be so treated for purposes of this requirement.

A special rule applies to contracts entered into before January 1, 1983. With respect to these contracts, the requirement is deemed satisfied if the contract clearly indicates that the worker is not an employee (either by specifying that the individual is an independent contractor or otherwise) and if the worker is provided with the required notice of tax responsibilities before February 1, 1983.

(5) Filing of required returns

This requirement is met if the service-recipient timely satisfies all information return requirements with respect to the service performed by the worker, or if the failure to do so by the service-recipient is due to reasonable cause and not to willful neglect.

Effect on other laws

A relationship which does not satisfy the safe-harbor test under the bill is to be classified under the usual common law rules applicable in determining employer-employee status, as if the safe-harbor test had not been enacted.

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[8] See Note 1, *supra*.

Qualification as an independent contractor under the safe-harbor test of the bill generally is to create no inference with respect to status under provisions of law other than Federal employment tax provisions. However, individuals who qualify as independent contractors under the safe-harbor test for employment tax purposes may not be treated as employees for purposes of tax provisions relating to employer-provided group-term life insurance (sec. 79), employee death benefits (sec. 101(b)), accident and health benefits (secs. 104, 105, and 106), group legal services (sec. 120), educational assistance programs (sec. 127), dependent care assistance programs (sec. 129), and pension, profit-sharing, stock bonus, or annuity plans.

Extension of interim relief provisions

The interim relief provisions of section 530 of the Revenue Act of 1978 are extended through December 31, 1982. However, the Treasury Department is not precluded from issuing (prior to 1983) regulations to implement the provisions of the bill dealing with independent contractors.

Employment tax treatment with respect to participation in certain home-health care programs

Under the bill, remuneration for services performed by certain individuals under a qualified home-health care program operated by a State will not be subject to Federal employment taxes, except that the State may elect to treat the individuals in the program as employees for social security purposes. In general, a qualified home-health care program is a program operated by a State or a State agency which provides cash grants to enable qualified clients to purchase authorized home-health care services. Authorized services generally are services for elderly or disabled individuals, or other individuals in need of such services, to whom such services are not otherwise reasonably and actually available (or provided) and who would without the availability of the services, reasonably be anticipated to require institutional care.[9] Qualified home-health care program grants are limited to clients who meet a low-income standard.

To qualify for employment tax exclusion, home-health care workers must be hired and supervised by the client. However, some supervision by the State will be permitted. For example, program supervision by State or local authorities to ensure that the services purchased are needed, that appropriate services are in fact being purchased, and that a client is not being defrauded will be permissible. Furthermore, if nonprofessional health care services are provided, State or local employees may provide insubstantial amounts of training or occasional supervision (i.e., not in excess of 15 percent of the time spent by the worker in providing home-health services).

Finally, for the employment tax exclusion to apply, the State must notify the client of the client's responsibility to notify the home-health care worker of his or her Federal income tax and employment tax responsibilities.

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[9] Authorized home-health care services include: (1) personal care, such as bathing, grooming, and toilet care; (2) assistance for patients who have limited mobility; (3) feeding and diet assistance; (4) home management, housekeeping, and shopping; (5) home-oriented recordkeeping; (6) family planning services; and (7) simple procedures for identifying potential health problems.

Effective Date

The safe-harbor provision of the bill applies to service performed after December 31, 1982.

b. Reduction of certain employment tax liabilities where workers are reclassified as employees (sec. 272 of the bill and new sec. 3509 of the Code)

Present Law

Three major problems may arise under present law if a worker who has been treated as an independent contractor is reclassified as an employee:

(1) The business whose workers are reclassified may be assessed FICA and FUTA employment taxes for years for which such assessment is not barred by the statute of limitations.

(2) Overpayments of income taxes may occur if the business is required to pay amounts as withholding of employee income tax liabilities with respect to which workers already had paid income tax (through estimated tax payments or with their returns).

(3) Overpayments of social security taxes may occur if the business is required to pay FICA taxes with respect to workers who already had paid self-employment (SECA) taxes.

If a worker reclassification occurs, the employer generally is responsible for all employment tax liabilities (income tax withholding, both the employer's and the employee's share of FICA taxes, and the FUTA taxes) with respect to the reclassified worker. Federal income tax withholding assessments may be adjusted if the reclassified worker pays (or has paid) the proper amount of income tax (sec. 3402(d)). However, the employer generally is not relieved of any applicable penalties or additions to tax for failure to timely pay over amounts as withholding.

The reclassified worker's share of FICA tax often is not adjusted to reflect the amount of SECA tax already paid on the same income. This is because present law (sec. 6521) authorizes a FICA-SECA offset only if the worker who has been reclassifed as an employee is prevented from filing for a refund of the SECA tax paid in error. This may result in the double collection of the employee's portion of social security tax: (1) once from the business as the FICA tax it initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error, if the employee could obtain a SECA tax refund but fails to do so.

Reasons for Change

The committee is aware that the employment status controversies that led to enactment of the interim relief provisions of the Revenue Act of 1978 were aggravated by the serious retroactive tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee.

The committee understands that, in a reclassification case, the Internal Revenue Service generally would adjust assessments for failure to withhold income taxes if the employer could furnish certificates, signed by the reclassified workers, showing that they had paid the taxes. However, in situations involving many workers and a high turnover rate, or in situations involving workers who were uncooperative or who maintained inadequate records, obtaining evidence to show whether the workers had paid the proper amounts of income taxes could be a difficult burden on the business. If certificates were not provided, the Internal Revenue Service generally would not provide information from its own records regarding employee tax payments unless discovery of such records was ordered in the context of civil litigation contesting the assessment.

The committee also understands that even where information on employer tax payments was available, problems arose with respect to possible double collection of social security taxes.

Accordingly, the committee bill provides a statutory offset mechanism that will apply in reclassification cases. This provision represents a substantial simplification of present law procedures and will reduce burdens on employers whose workers are reclassified.

Explanation of Provision

The bill provides a new procedure for determining an employer's liability for failure to withhold income taxes or the employee's share of FICA taxes in certain situations involving worker reclassifications. Even where this procedure applies the employer still will be liable for the employer's share of FICA taxes and FUTA taxes.

If an employer treats services performed by an employee as if performed by a nonemployee and fails to withhold income or social security taxes as required by the wage withholding provisions of the income tax and social security tax laws, the employer's liability for those amounts will be determined as a fraction of the employee's wages subject to income tax withholding or a fraction of the social security taxes required to be withheld. The fraction in the bill is designed to approximate the average amount of liability the employer would incur under current law after reducing the employer's initial liability by the amount of taxes paid by the employee. The bill applies a lower fraction if the employer has complied with information reporting rules consistent with the treatment of the employee as a nonemployee. This lower fraction reflects the increased tax compliance that results when information reports are filed with the Internal Revenue Service.

The applicable amounts are 1.5 percent of wages (3 percent where no information returns are filed) where the employer erroneously treated the worker as a nonemployee for income tax purposes. The applicable amount where the employer erroneously treated the worker as a nonemployee for social security purposes is 20 percent of the social security taxes required to be withheld (40 percent where no information returns are filed).

In a typical reclassification case, an amount for both income and social security taxes will be assessed. In some reclassification cases, however, the employer may treat the worker as an employee for social security purposes but not for income tax purposes, in which case only the income tax amount will be assessed.

Where the employer treats the worker as an employee for income tax purposes but not for social security tax purposes, these provisions will not apply; instead, present law will apply.

Although these fractional amounts are set at levels reflecting assumed levels of taxpayer compliance, the committee believes that the amounts also reflect appropriate sanctions for an employer's erroneous failure to withhold taxes from compensation paid to an employee, regardless of the actual level of taxpayer compliance in any particular case. Accordingly, the committee believes that the assessment of these amounts will serve the dual function of deterring noncompliance on the part of employers, and compensating the Treasury for the revenue loss typically associated with employer noncompliance with wage withholding.

These reduced amounts generally are to be treated as the tax the employer should have withheld and paid currently under Code sections 3402 or 3102. The deductibility of these amounts is to be determined as if they were assessments for taxes that the employer failed to deduct and pay over, taking into account the bill's provisions denying the employer any right to claim reimbursement from the employee.

In order to deter intentional noncompliance with the wage withholding requirements, these provisions do not apply if the employer treats the employee as a nonemployee with intentional disregard of the law. Furthermore, the FICA tax liabilities of statutory FICA tax employees are not covered by these provisions.

Effective Date

This provision is effective on enactment. However, the provision does not apply to assessments made before January 1, 1983.

c. Tax Court jurisdiction over certain employment tax issues (sec. 273 of the bill and sec. 6211 of the Code)

Present Law

Under present law, the U.S. Tax Court does not have jurisdiction over disputes involving Federal employment taxes (sec. 6211). Thus, to challenge assessment of an employment tax in court, the taxpayer generally must pay the tax, file a claim for refund, and (if the claim is denied) sue in a U.S. District Court or the U.S. Court of Claims (after September 1982, the U.S. Claims Court).

Since employment taxes are "divisible", however, a taxpayer generally may challenge an employment tax assessment merely by paying the tax for one worker for one quarter, and then suing for a refund of that tax.[1] Generally, such a refund suit also includes a claim for an abatement of the unpaid, but previously assessed, taxes. The Internal Revenue Service ordinarily counterclaims in the litigation for the balance of the assessment. This procedure allows a resolution of employment tax issues without payment of the full amount of the employment tax assessment prior to litigation.

Reasons for Change

Because a proposed employment tax adjustment may not be contested in the Tax Court prior to assessment, the Internal Revenue Service is not barred from filing tax liens on the basis of the assessment, or from otherwise seeking to collect an employment tax assessment while it is being disputed in the courts. The committee understands that it is the policy of the Internal Revenue Service generally to forebear from active collection efforts while refund litigation is pending, if the government's interests are not so jeopardized. However, the filing of a tax lien cannot be prevented without full payment of the assessment (or the posting of a bond backed by full cash collateral). A substantial tax lien can result in serious financial difficulties for a business. Thus, the committee believes it is appropriate to permit judicial review of a reclassification case before assessment of employment taxes and the filing of tax liens. The committee believes that the addition of employment tax status issues to the Tax Court's jurisdiction will not significantly increase the court's caseload, since the potential number of such cases is estimated to represent a small fraction of the court's current caseload.

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[1] See, e.g., *Marvel* v. *U.S.*, 548 F. 2d 295 (10th Cir. 1977).

Explanation of Provision

The provision extends the jurisdiction of the U.S. Tax Court to include reclassification employment tax issues.

Effective Date

The provision applies with respect to employment tax liabilities arising out of services performed after December 31, 1982.

d. Revenue effect*

The provisions (in this section F-1) are estimated to reduce fiscal year budget receipts by $207 million in 1983 and $86 million in 1984, and to increase fiscal year budget receipts by $86 million in 1985, $128 million in 1986, and $145 million in 1987.

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*The revenue estimate takes into account the reporting requirements and penalties applicable to direct sales and compensation for services performed by nonemployees, included in section C of this report.

2. Federal unemployment tax (FUTA) provisions (sec. 275 of the bill, secs. 3301, 3302, 3306, and 6157 of the Code, and sec. 901 of the Social Security Act)

Present Law

Under the Federal Unemployment Tax Act (FUTA), employers are subject to a payroll tax of 3.4 percent on the first $6,000 of wages per employee per year. If a State unemployment insurance law meets the requirements of Federal law, employers in that State generally receive a 2.7 percent credit against the Federal tax, for a net Federal tax of 0.7 percent. The net effective Federal tax rate will automatically drop by 0.2 percent (to 0.5 percent) when the general fund of the Treasury is repaid the outstanding loans made to the extended benefit account.

States also levy unemployment compensation taxes in order to finance benefit payments. Almost all jurisdictions determine an employer's tax rate under a system of experience rating in which the tax rate depends on total unemployment benefits recently paid to an employer's former employees. Federal law requires that no reduced rate (usually a rate below 2.7 percent) may be assigned to an employer except on the basis of the employer's experience rating.

Both the State and Federal taxes are part of the Federal budget and are deposited in the Federal Unemployment Trust Fund. State tax revenues are used to pay regular State benefits and one-half of the cost of extended benefits. Federal tax revenues are used for State and Federal administrative costs and the remaining half of the cost of extended benefits, and to maintain a loan fund from which a State may borrow when it lacks funds to pay State benefits.

Reasons for Change

The unemployment program is seriously underfinanced. Recessions of the 1970s and inadequate State and Federal funding have led to substantial deficits currently being financed through Trust Fund borrowing from the Federal Treasury. Outstanding borrowing from the Treasury was equal to $13.1 billion at the end of fiscal year 1981. Total State debt to the Trust Fund is expected to increase in 1982 because of additional State borrowing.

The taxable Federal wage base has not been increased since 1978, thus Federal revenues have not kept up with the increases since that year in benefit and administrative costs.

Explanation of Provision

Effective January 1, 1983, the Federal unemployment tax (FUTA) wage base would increase to $7,000 and the tax rate will be raised to 3.5 percent, thus increasing the net effective Federal tax rate from 0.7 to 0.8 percent. In States which now have a taxable wage base below $7,000 and which automatically conform their wage base to the Federal base, this change will also result in an increase (to $7,000) in the taxable wage base for State unemployment taxes.

Effective January 1, 1985 the Federal tax rate will increase to 6.2 percent (a permanent tax of 6.0 percent and an extended benefit tax of 0.2 percent), and the credit will be increased to 5.4 percent. This change does not affect the net Federal tax rate, which remains at 0.8 percent. It does, however, increase the standard State tax rate from 2.7 to 5.4 percent. This means that States allowing reduced rates below 5.4 percent will have to do so on an experience rating basis.

Under present law, the Federal tax credit may, subject to certain limitations, be reduced for employers in States which have borrowed and not repaid funds to meet shortfalls in their unemployment accounts. In general, these credit reductions, when applicable, begin at a rate of 0.3 percent per year and increase at a rate of 0.3 percent per year, subject to certain limitations. This provision is not changed in any way under the bill.

Effective Date

The increase in the wage base to $7,000 and the increase in the rate to 3.5 percent are effective for wages paid after December 31, 1982. The increase in the tax rate to 6.2 percent and the increase in the credit rate to 5.4 percent are effective for wages paid after December 31, 1984.

Revenue Effect

This provision increases fiscal year budget receipts by $1,404 million in 1983, $2,353 million in 1984, $2,856 million in 1985, $2,818 million in 1986, and $2,554 million in 1987.

3. Extension of Social Security Hospital Insurance Taxes and Medicare coverage to Federal employees (sec. 276 of the bill, secs. 3101 and 3111 of the Code, and secs. 213, 226, 226A, and 1811 of the Social Security Act)

Present Law

Under current law, entitlement to protection under the Hospital Insurance or Part A portion of the Medicare program for most individuals is linked to entitlement to monthly social security retirement or survivor benefits or to railroad retirement benefits. This entitlement is earned through work in employment covered by the social security or railroad retirement system. Workers help finance the costs of hospital insurance benefits by payment of the hospital insurance tax (currently 1.3 percent) on wages subject to social security taxation. Present law excludes certain kinds of employment from the social security system and from paying social security taxes, including Federal civilian employment that is covered under a staff retirement system established by a law of the United States. Regular Federal employees, including postal workers, are covered under such retirement systems. They pay no Hospital Insurance taxes, nor do they become entitled to Hospital Insurance benefits on the basis of such employment.

Reasons for Change

Many active Federal civilian employees have worked long enough (or their spouses have) in employment covered by social security to become insured under the Hospital Insurance program. However, while most workers in covered social security employment are subject to the Hospital Insurance tax throughout their entire working careers, Federal employees may earn the same coverage with relatively fewer years of work subject to the tax. The committee believes that Federal workers should bear a more equitable share of the costs of financing the benefits to which many of them eventually become entitled.

The bill, therefore, extends Medicare coverage to all members of the Federal workforce in the same way coverage is provided to most other workers. Federal employees will earn equivalent quarters of coverage for Hospital Insurance by paying the HI tax on their wages. Employees earning 40 or more quarters of coverage from work in Federal employment or in any combination of Federal and other employment subject to the HI tax would qualify for Hospital Insurance benefits just as other workers now do. Federal employees nearing retirement would be grandfathered in with reduced quarters of coverage requirements.

Explanation of Provision

The committee bill subjects Federal employees, including postal workers, to the Hospital Insurance tax, and will entitle individuals who have been Federal employees and who reach age 65 years of age, suffer from end-stage renal disease, or become disabled to Medicare Hospital Insurance after paying Hospital Insurance taxes for the same number of years (usually 10) that is required of most other workers. Individuals who have attained age 57 by 1983 and who are Federal employees on January 1, 1983, would have a reduced number of additional years of employment required (with no additional years required for those who have attained age 65 by 1983) for purposes of determining their eligibility for Medicare benefits.

Effective Date

The provision is effective on January 1, 1983.

Revenue Effect

This provision will increase fiscal year receipts by $617 million in 1983, $837 million in 1984, $927 million in 1985, $1,066 million in 1986 and $1,163 million in 1987. Outlays will be increased by approximately $25 million in fiscal year 1983, $50 million in 1984, and $75 million in 1985.

G. Excise Tax Provisions

1. Airport and Airway Trust Fund Taxes and transfers (secs. 281-283 of the bill and secs. 4041(c), 4081, 4261, 4271, and 9502 of the Code)

Present and Prior Law

Overview

The Airport and Airway Revenue Act of 1970 (title II of Public Law 91-258) increased some existing aviation excise taxes, imposed several additional aviation excise taxes and established the Airport and Airway Trust Fund to receive revenues from these excise taxes. These excise taxes were allowed either to expire or to be reduced on October 1, 1980. The revenues from the aviation-related taxes went into the Airport and Airway Trust Fund for the period July 1, 1970, through September 30, 1980 (the "trust fund period").

Air passenger ticket tax

In the case of air passenger transportation within the United States, an excise tax is imposed equal to 5 percent of the amount of the air fare (sec. 4261(a)). Revenues from the tax currently go into the general fund.[1]

Air transportation between the United States and a foreign location which is not more than 225 miles from the nearest point in the continental United States (defined as only within Canada and Mexico), as well as between two such foreign locations, generally is subject to the 5-percent tax where payment for the travel is made in the United States. This tax does not apply to transportation between the United States and other foreign locations where payment is made outside the United States, nor does it apply to the U.S. portions of certain uninterrupted international air transportation. Also, the 5-percent passenger tax does not apply to the portion of flights to or from or between Alaska and Hawaii which are not made over the United States.

International departure tax

During the trust fund period, a $3 per passenger departure tax applied to international air transportation that began in the United States, and also to flights between the continental U.S. and Alaska or Hawaii or between Alaska and Hawaii.[2] This tax expired on October 1, 1980 (sec. 4261(c)).

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[1] The air passenger ticket tax was 8 percent for the period July 1, 1970, through September 30, 1980, with the revenues deposited into the Airport and Airway Trust Fund. The pre-trust fund period ticket tax rate was 5 percent.

[2] For the prior law $3 international departure tax to have applied in lieu of the domestic air passenger ticket tax, the air transportation must have been an uninterrupted international

Continued

Air freight waybill tax

In the case of air transportation of property, the 1970 Act imposed a tax of 5 percent of the air freight waybill charge (sec. 4271). This tax expired on October 1, 1980. In determining taxable transportation, the same rules generally applied as for transportation of persons, except that the air freight tax applied only to amounts paid for transportation of property by air beginning and ending in the United States (sec. 4271), i.e., the tax did not apply to the international portion of flights from the continental U.S. to or from Alaska or Hawaii or between Alaska and Hawaii.

Other aviation excise taxes

In addition to the taxes on air passenger fares and air freight waybill charges, during the trust fund period there was a 7-cents-per-gallon tax on aviation fuels (gasoline and other fuels, including jet fuels) used by noncommercial (general) aviation (secs. 4041(c) and 4081), an aircraft use tax,[3] and a tax on aircraft tires and tubes.[4] Fuels for use by commercial aviation are and have been exempt from the taxes on gasoline and other fuels.[5]

The tax on noncommercial aviation gasoline was allowed to decline to 4 cents per gallon on October 1, 1980, while the 7-cents-per-gallon tax on nongasoline fuels (e.g., kerosene—jet fuels) used by noncommercial aviation was allowed to expire on October 1, 1980. The aircraft use tax was new under the 1970 Act, and it also expired on October 1, 1980. The tax on aircraft tires and tubes was merely a transfer of revenues from the excise taxes on such tires and tubes from the Highway Trust Fund to the Airport and Airway Trust Fund during the trust fund period.

Exemptions

Exemptions from the air passenger taxes and the waybill tax have been and are provided for transportation by small aircraft on nonestablished lines (sec. 4281) and for private air transportation services provided within a group of affiliated corporations (sec. 4282). Aircraft not subject to the passenger or freight taxes are subject to the applicable fuels tax.

There is also a general exemption (or a refund or credit) from the aviation fuels taxes for fuel sold for use (or used) on a farm for farming purposes. Also, the taxes on aviation fuels do not apply to aircraft owned by a tax-exempt aircraft museum operated exclusively for the procurement, care, and exhibition of World War II aircraft. Further, there are also general exemptions from the fuel taxes for fuel sold for use (or used) by a State or local government, by a nonprofit educational organization, and for exported fuels.

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flight from a point beginning in the United States and ending outside the United States (and outside the 225-mile zone in Canada and Mexico). An uninterrupted international flight may have a stopover at a domestic point of not more than 6 hours without being subject to the domestic ticket tax under present law.

[3] A tax of two parts: (1) a $25 annual per plane tax, plus (2) a weight tax of 3½ cents per pound for turbine-powered (jet) aircraft and 2 cents per pound for nonturbine-powered aircraft for each pound in excess of 2,500 pounds of "maximum certificated takeoff weight (sec. 4491)."

[4] Taxed at the general rates for nonhighway tires (5 cents per pound prior to January 1, 1981, and 4.875 cents per pound since) and tubes (10 cents per pound) under section 4071. (Under present law, the tax on tubes is scheduled to decline to 9 cents per pound on October 1, 1984.)

[5] Commercial aviation is subject to the air passenger ticket tax in lieu of the fuels tax (and previously was also subject to the air freight waybill tax).

Trust fund authorization purposes

The Airport and Airway Trust Fund was established as of July 1, 1970 (Title II of Public Law 91-258). Transfer of aviation-related excise tax revenues into the Trust Fund terminated as of October 1, 1980.

The 1970 Act provided that the aviation excise taxes imposed by the Act were to be deposited into the Trust Fund and, with interest earned on the deposits, were to be available to meet specified airport and airway obligations of the United States incurred under Title I of the 1970 Act, as it was in effect on the date of enactment. As a result, subsequent expansion of trust fund budget authority required corresponding amendments to the trust fund statute.

The following outline presents a summary listing of the Airport and Airway Trust Fund expenditure programs authorized under the 1970 Act as amended.

a. *Airport Development Aid Program (ADAP).—*

(1) *Airport planning.*—Grants to planning agencies for airport system planning and public agencies for airport master planning; airport noise compatibility planning grants for air carrier airports eligible for terminal development costs.

(2) *Airport development projects:*

> *(a) Airport construction.*—Construction, improvement or repair of a public airport (includes removal of airport hazards and construction of physical barriers and landscaping to diminish noise).
>
> *(b) Airport terminal facilities.*—Nonrevenue-producing public use areas which are directly related to movement of passengers and baggage (includes baggage facilities and passenger-moving equipment) at air carrier airports, the sponsors of which certify that they have the required safety and security equipment; does not include costs of constructing public parking facilities for passenger automobiles or costs to construct, alter, or repair a hangar or any airport building unless used to house facilities or activities directly related to safety of persons at the airport; authorized uses of funds also include multimodal terminal development and bond retirement for certain airports.
>
> *(c) Land acquisition.*—Includes land or property interests for airport noise control purposes.
>
> *(d) Airport-related equipment.*—Airport security equipment required by Department of Transportation regulations, snow removal equipment, noise suppressing equipment, navigation aids, and safety equipment required for airport certification.
>
> *(e) Airport noise compatibility programs.*—Includes soundproofing of public buildings; local governmental units are eligible for project grants as well as airports.

b. *Facilities and Equipment Program (F&E).*—Costs of acquiring, establishing, and improving air navigation facilities.

c. *Research, Engineering, Development, and Demonstration Program (R.E. & D.).*—Projects in connection with Federal Aviation Administration research and development activities.

d. *Operations and Maintenance Programs (O&M).*—Flight checking and maintenance of air navigation facilities; services provided under international agreements relating to the joint financing of air navigation services assessed against the U.S. Government.

e. *Other costs.*—Certain airline costs of international passenger security screening facilities and related services.

Reasons for Change

The committee determined that the needs of the air transportation system require additional revenues and that resumption of funding of the Airport and Airway Trust Fund with these revenues is the most appropriate manner in which to insure that sufficient funds are available to finance the system's needs. Therefore, the committee believes that the excise taxes on air passengers and airfreight should be increased to or reimposed at their trust fund period levels and the revenues from those taxes transferred to the Trust Fund.

The committee further concluded that noncommercial (general) aviation makes significant use of the airport and air navigation systems financed by the aviation excise taxes, and therefore should pay a greater share of the system's costs for such use into the Trust Fund. Also, the committee believes that the prior law aircraft use tax should not be reenacted. In addition, the committee determined that the excise tax on aircraft tires and tubes should again be transferred to the Airport and Airway Trust Fund.

The committee estimates that this level of taxes will provide funds for necessary future trust fund expenditures, and therefore should avoid possible significant future tax increases to finance a modernized, expanding air transportation system.

Further, the committee determined that in light of the user fee concept of these taxes, certain helicopters used in timber and natural resource operations that do not use Federally-financed airports or airway system facilities should be exempt from the taxes on aviation fuels.

Explanation of Provisions

Tax rates

Under the committee bill, the air passenger ticket tax is increased to 8 percent; the air freight waybill tax is reimposed at a 5-percent rate; and the international departure ticket tax is reimposed at a $3-per-passenger rate. In addition, the present tax on aircraft gasoline fuels is increased to 12 cents per gallon and a 14-cents-per-gallon tax is imposed on nongasoline (e.g., kerosene—jet) fuels.[6]

Under the committee bill, the increased and reimposed taxes are made permanent at their new rates.

Exemption for fuels used in certain helicopters

The committee bill also provides for an exemption (via a refund or credit) for fuels used in helicopters when the helicopters are used for certain qualified purposes, if the helicopter does not (1) take off from or land at a facility eligible for assistance under the Airport and Airway Development Act of 1970, as amended, or (2) otherwise use Federal airway system facilities or services.

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[6] The prior law aircraft use tax is repealed from the Code as deadwood.

Specifically, the fuels taxes will not be imposed when the helicopter is used for (1) transporting individuals, equipment or supplies in the exploration for, or the development or removal of, natural resources, or (2) the planting, cultivation, cutting, or transportation of, or caring for, trees (including logging operations). For example, fuels used by helicopters which are transporting persons engaged in the exploration for petroleum will qualify for exemption from the fuels tax under the natural resources exemption, when departing from, or arriving at, heliports or airports not eligible for ADAP assistance; however, if in its flight pattern, a helicopter follows FAA air navigation signals, the fuel used in that flight is not exempt from the excise tax. The committee intends that this exemption will cover helicopters used in transporting persons and property from the Outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act (43 U.S.C. 1331)) when engaged in natural resources operations, and when the requirements concerning nonuse of the FAA system are satisfied.

The forestry exemption covers fuels used in tree farming and timber harvesting activities. This is intended to include, for example, fuels used by helicopters engaged in fire control or insect control of trees, as well as in tree cultivation and in logging operations.

The exemptions from the fuels tax provided by this provision apply only to fuels used in the qualifying activities. If fuel is delivered into the fuel supply tank of a qualified helicopter and such fuel is used partly for qualified purposes and partly for nonqualified purposes, the tax will apply to that portion of the fuel which is used for the non-qualified purposes. In addition, the committee intends that the rules and regulations under sections 4041 and 6427 will govern the application of these exemptions. Thus, present law registration, refund, and credit procedures will apply.

Extension of trust fund provisions and transfers to the fund

The committee bill makes permanent the authority for expenditures from the Airport and Airway Trust Fund and again transfers aviation excise tax receipts to the Trust Fund. Receipts from the aviation excise taxes extended or reinstated under the bill and revenues from the taxes on aircraft tires and tubes (presently deposited in the Highway Trust Fund) will be transferred to the Trust Fund on a permaent basis beginning on September 1, 1982. These monies and the interest earned thereon will be available to fund airport and airway program authorizations as indicated below.

Trust fund expenditure purposes

Expenditures from the Trust Fund may be made, as provided by appropriation Acts, to meet obligations incurred under title I of the Airport and Airway Development Act of 1970, or of the Airport and Airway Development Act Amendments of 1976, or of the Aviation Safety and Noise Abatement Act of 1979, or under the Fiscal Year 1981 Airport Development Authorization Act (as such Acts were in effect on the date of enactment of the Fiscal Year 1981 Airport Development Authorization Act), or incurred under the provisions of the Airport and Airway System Development Act of 1982, (as such provisions were contained in such legislation as reported by the Senate Committee on Finance). Expenditures also may be made to meet obligations incurred under the Federal Aviation Act of 1958, as amended, which are attributable to planning, research and development, construction or operation and maintenance of (1) air traffic control, (2) air navigation, (3) communications, or (4) supporting services for the airway system. In addition, expenditures may be made for the portions of the administrative expenses of the Department of Transportation that are attributable to the activities described in this paragraph.

Under a separate provision approved by the committee (Airport and Airway System Development Act of 1982), trust fund authorizations are made for fiscal years 1982–1987. Funding for the airport development program (ADAP) would increase from $450 million in fiscal year 1982, to $600 million in fiscal years 1983, 1984 and 1985, and to $1,049.4 million in fiscal year 1986 and $1,206.8 million in fiscal year 1987. Total trust fund authorizations would increase from $1,733 million in fiscal year 1982 to $3,018 million in fiscal year 1983, to $4,029.4 million in fiscal year 1986 and $4,007.8 million in fiscal year 1987. Under the authorization and tax provisions approved by the committee, the uncommitted balance in the Trust Fund would decline to an estimated $1.7 billion at the end of fiscal year 1987.

The expenditure purposes that will be authorized from the Airport and Airway Trust Fund include the following activities:

1. Capital improvements to airports designed to enhance safety, relieve congestion or improve noise abatement; minimum funding levels for reliever and other general airports.
2. Federal Aviation Administration programs to modernize and maintain the air traffic control system, flight services and weather forecasting.
3. A State block grant program that enables the States to allocate funds to specific airports independent of project grants provided by the Federal Government.
4. Submission of a report to Congress within one year of enactment of this bill about whether a defederalization program should be put into effect, and whether passenger facility charges should be instituted and in what form.
5. Voluntary withdrawal from the Federal airport improvement program while remaining eligible for Federal funds for land acquisition or noise abatement programs; relief from some FAA contract requirements if withdrawn from program.

Transfer of trust fund provisions to the Internal Revenue Code

Under the committee bill, provisions which establish the Airport and Airway Trust Fund and relate to its management, and provisions by which amounts appropriated to the Trust Fund are transferred from the general fund of the Treasury will become provisions of the Internal Revenue Code of 1954. The Airport and Airway Trust Fund transferred to the Code by the bill will be treated for all purposes of law as the continuation of the Airport and Airways Trust Fund established by Title II of Public Law 91-258.

The bill standardizes and updates provisions of the Airport and Airway Trust Fund to conform to the language of other trust funds. The committee intends no other substantive effect in deleting archaic language in the existing trust fund statute.

Effective Dates

The amendments to the air passenger, freight waybill, and international ticket taxes apply to tickets or waybills sold after August 31, 1982.

The amendments to the fuels taxes apply with respect to fuels sold after August 31, 1982.

The trust fund provisions are effective on September 1, 1982.

Revenue Effect

The net increase in budget receipts (after accounting for lower income tax receipts) over present law taxes as a result of enacting the provisions in this section will be $813 million in fiscal year 1983, $957 million in fiscal year 1984, $1,084 million in fiscal year 1985, $1,210 million in fiscal year 1986, and $1,350 million in fiscal year 1987.

The following table presents details of the revenue effects of the aviation exicse tax provisions for fiscal years 1983-1987.

ESTIMATED AIRPORT AND AIRWAY TRUST FUND RECEIPTS UNDER H.R. 4961 AS REPORTED, FISCAL YEARS 1983-87 [1]

[In millions of dollars]

Tax	1983	1984	1985	1986	1987
Air passenger ticket tax (8 percent)	2,192	2,532	2,881	3,255	3,663
Air freight waybill tax (5 percent)	110	130	147	168	191
International departure tax ($3 per person)	75	82	85	88	92
Fuels tax for noncommercial general aviation [3]	124	130	138	141	148
Aircraft tires and tubes taxes [4]	1	1	1	1	1
Total trust fund receipts	2,502	2,875	3,252	3,653	4,095
Total, gross receipts of trust fund taxes in excess of present law aviation taxes [5]	1,084	1,276	1,445	1,613	1,800

ESTIMATED AIRPORT AND AIRWAY TRUST FUND RECEIPTS UNDER H.R. 4961 AS REPORTED, FISCAL YEARS 1983-87 [1]—Continued

[In millions of dollars]

Tax	1983	1984	1985	1986	1987
Total, net budget receipts of (aviation) taxes in excess of present law [6]	813	957	1,084	1,210	1,350

Note: Details may not add to totals due to rounding.

[1] All revenues from airport and airway taxes received after August 31, 1982 are to be transferred to the trust fund. An estimated $115 million, attributable to existing law aviation, will be received in the Trust Fund in fiscal year 1982.

[2] Less than $5 million.

[3] For noncommerical aviation gasoline the tax is 12-cents-per-gallon, and for nongasoline fuels 14-cents-per-gallon.

[4] Extended at present law rates.

[5] Excludes certain existing law tax collections which would under the provision now be transferred to the Airport and Airway Trust Fund.

[6] This estimate represents the net increases in budget receipts after accounting for lower income receipts.

2. Increase in telephone excise tax (sec. 284 of the bill and sec. 4251 of the Code)

Present Law

A 1-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service and teletypewriter exchange service (sec. 4251). The tax is paid by the person who pays for service to the person rendering the service, who in turn remits the tax to the general fund of the Treasury.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, and State and local governments. Other exemptions include amounts paid for installation charges and for certain calls from coin-operated telephones (sec. 4253).

This excise tax is scheduled to terminate, effective with respect to amounts paid pursuant to bills first rendered on or after January 1, 1985.

Reasons for Change

The committee determined that continuation of the telephone excise tax at an increased rate is appropriate at this time. This excise tax has been in effect since 1941; the tax rate was 10 percent until 1973. In the past, the tax has typically included an expiration date; however, before each scheduled expiration, Congress has found it necessary to extend the tax. To provide consistency and to reduce future uncertainty about continuation of the tax, the committee believes that the tax should be made permanent at this time.

Explanation of Provision

The bill increases the telephone excise tax rate to 2 percent in calendar year 1983, 3 percent in calendar years 1984 and 1985, and 2 percent in years after 1985.

Effective Date

The 2-percent rate applies to amounts paid pursuant to bills rendered on or after January 1, 1983; the 3-percent rate applies to amounts paid pursuant to bills rendered on or after January 1, 1984; and the 2-percent rate again applies to amounts paid pursuant to bills rendered on or after January 1, 1986.

Revenue Effect

It is estimated that this provision will increase net fiscal year budget receipts by $308 million in 1983, $881 million in 1984, $1,600 million in 1985, $1,599 million in 1986, and $1,503 million in 1987.

3. Increase in cigarette excise tax (sec. 285 of the bill and sec. 5701 of the Code)

Present Law

Excise taxes are imposed on cigarettes manufactured in or imported into the United States (sec. 5701). In general, the manufacturer or importer is liable for these taxes (sec. 5703), which are determined when the products are removed from the factory or released from customs custody (i.e., upon removal from bonded premises).

The rate of tax on small cigarettes (those which weigh no more than 3 pounds per thousand) is $4 per thousand, which is equal to 8 cents per pack of 20 cigarettes. Generally, the rate of tax on large cigarettes (those which weigh more than 3 pounds per thousand) is $8.40 per thousand, except that higher rates apply to large cigarettes that exceed 6.5 inches in length.

Reasons for Change

The present cigarette excise tax rates have not been increased since 1951. Since the tax is imposed as a set amount, rather than as a percentage of sales price, the effective level of the tax has declined by more than 70 percent in constant dollars since it was last amended. The committee believes, therefore, that an adjustment to the tax is appropriate at this time. Doubling the tax rate, as is done under the committee bill, will not increase the per-pack tax, in real terms, above the 1951 level.

Explanation of Provision

Tax rates

The bill increases the rate of tax on small cigarettes to $8.00 per thousand, which is equal to a tax rate of 16 cents per pack. The rate of tax on large cigarettes, less than 6.5 inches in length, is increased to $16.80 per thousand, which is equal to a tax rate of 33.6 cents per pack.

Floor stocks tax

The bill also includes provisions extending the doubled rates of the cigarette excise taxes to certain floor stocks. Under the bill, an additional tax is imposed on each manufacturer, importer, or wholesale distributor holding cigarettes on January 1, 1983, for sale to a retailer, which cigarettes were removed from bonded premises before that date and a tax at the pre-1983 rates imposed at the time of such removal. The additional tax is equal to the excess of the tax that would apply to removal of the cigarettes from bonded premises on or after January 1, 1983, over the tax that was previously collected on such cigarettes. This additional tax is to be collected from the manufacturer, importer, or wholesale distributor as if the cigarettes had been removed from bonded premises on January 1, 1983.

Effective Date

This provision applies to cigarettes removed from bonded premises after December 31, 1982, and to floor stocks held by persons other than a retailer on January 1, 1983.

Revenue Effect

It is estimated that this provision will increase net fiscal year budget receipts by $1,275 million in 1983, $1,829 million in 1984, $1,859 million in 1985, $1,884 million in 1986, and $1,907 million in 1987.

4. Expansion of Dingell-Johnson Fund excise tax on fishing equipment and new excise tax on recreational boats and boating equipment (sec. 286 of the bill and sec. 4161 of the Code)

Present Law

Excise tax on fishing equipment

An excise tax equal to 10 percent of the price is imposed on the sale of fishing rods, creels and reels, and on artifical lures, baits, and flies (including parts and accessories of such articles) by a manufacturer, producer, or importer (sec. 4161(a)).

Treasury Department regulations require returns of manufacturers excise taxes, including the tax on the sale of fishing equipment, to be filed quarterly, unless the Internal Revenue Service requires more frequent filing by an individual taxpayer (Treas. Reg. § 48.6011(a)-1). Quarterly returns are due on the last day of the first month after the quarter ends (Treas. Reg. § 48.6071(a)-1).

Although returns generally are filed on a quarterly basis, the regulations require monthly, or semimonthly, payment of the tax in certain cases (Treas. Reg. § 48.6302(c)-1). If a taxpayer is liable in any month for more than $100 of manufacturers excise tax and is not required to make semimonthly deposits, the taxpayer must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the taxpayer is located.

If a taxpayer had more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, such taxes must be deposited for the following quarter (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are deposited.

Dingell-Johnson Fund expenditure purposes

Revenues equivalent to the 10-percent excise tax on fishing equipment are distributed to the States in partial reimbursement of the costs they incur in various fish restoration and management projects.[1]

These amounts are appropriated to reimburse States up to 75 percent of the cost of approved projects, which include research into problems of fish management and culture, surveys and inventories of fish populations, restocking waters with food and game fishes according to natural areas, and acquisition and improvement of fish habitat that provide access for public use. The amount of assistance for these programs is determined by statutory formula and is distributed to the 50 States and the District of Columbia,

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[1] 16 U.S.C. § 777b.

Puerto Rico, Guam, the Virgin Islands, American Samoa, and the Northern Marianas.

Reasons for Change

The Dingell-Johnson Fund program has resulted in hundreds of new lakes and boating access areas being built and in extensive fisheries research and enhancement. The committee believes the need to bolster the efforts of State fish and wildlife agencies in managing recreational fisheries is even more compelling today than it was when the Dingell-Johnson Fund program was first enacted in 1950. The committee has determined that this program should continue to be financed by the beneficiaries of its projects in a manner consistent with present practice. Therefore, the committee has expanded the articles on which the manufacturers excise tax on fishing equipment is imposed. The committee also has decided to extend the excise tax, at a 3-percent rate, to recreational boats and boating equipment, with the revenues to be used for the Dingell-Johnson Fund program.

The committee has been informed that the present time for payment of the excise tax on fishing equipment can create hardship in some cases because of the particular nature of the fishing equipment industry. The committee determined that special provisions were needed to match the time for payment of the tax more closely to the time the manufacturer receives payment for goods sold on credit. The committee believes, however, that this particular problem is unique to the fishing equipment industry, and intends that no inference be drawn from this change with respect to the appropriate time for payment of any other excise tax.

Explanation of Provisions

a. Excise tax on fishing equipment

The committee bill expands the types of articles subject to the 10-percent manufacturers excise tax on fishing equipment to include fishing tackle items not presently covered. Under the committee bill, the articles of sport fishing equipment subject to the 10-percent excise tax includes, for example, fabricated rods, poles, and component parts of such rods and poles; organic, synthetic, and metallic lines; underwater riggers; underwater spreaders; bags and baskets designed to hold fish; portable bait containers; landing nets; hoops; gaff hooks; rodholders; preserved packaged bait; ice augers; ice spuds, manufactured ice houses; and other items which are commonly used in sport or recreational fishing. In the case of fabricated rods and poles, the term component part is intended to include rod blanks, reel seats, handles, guides, ferrules, lets, as well as any other similar terms.

The committee is aware that certain types of fishing equipment can be used in both commercial and recreational fishing. The committee intends, to the extent possible, to tax only items used in recreational fishing. Because the excise tax is a manufacturers tax and the specific use of any indivudual item of this nature cannot be determined at the time the item is sold by the manufacturer, the committee anticipates that the Treasury Department will by regulation develop guidelines which insure that individual varieties of these dual-purpose items which are primarily used in recreational fishing are subject to the tax while the varieties which are primarily used in commercial fishing are not taxed.

For example, the committee understands that under present practice, fishing lines testing 80 pounds or less are primarily used in recreational fishing while those lines testing in excess of 80 pounds are primarily used for commercial purposes. The committee anticipates, therefore, that the Treasury Department regulations will interpret the statute to provide that only those lines testing 80 pounds or less are subject to the tax, as long as present practices remain unchanged. Additionally, the committee understands that at the present time, landing nets and gaff hooks with handles in excess of six feet are primarily used for commercial purposes while those with handles six feet or less in length are used primarily for recreational fishing. The committee, therefore, anticipates that Treasury regulations will interpret the statute to include only those items with handles six feet or less in length. The committee also understands that minnow traps, while generically a type of portable bait container, are presently used primarily in commercial fishing. The committee anticipates, therefore, that the Treasury will interpret the term portable bait container to exclude minnow traps unless a recreational fishing market develops for them.

b. Excise tax on recreational boats and boating equipment

Under the committee bill, a 3-percent manufacturers excise tax is imposed on recreational boats less than 20 feet in length, which are designed for fishing or which have a capacity label that limits the outboard motor rating to 50 horsepower or less, and on component parts of such boats (other than outboard motors) that are sold in connection with the boats.

The term recreational fishing boat includes rowboats as well as inboard and outboard motor-powered boats. The tax does not apply to sailboats, kayaks, hydroplanes, double-ended canoes, and boats designed chiefly for commercial purposes (other than commercial purposes related to recreational fishing).

Additionally, boating equipment primarily designed for use on recreational fishing boats is subject to the tax even though not actually sold with such a boat. Taxation of component parts sold separately from a fishing boat will prevent circumvention of the excise tax by selling a hull to a retailer who would then outfit the hull with appropriate fishing or recreational boating equipment.

The 3-percent excise tax is also to apply to certain types of boating equipment in addition to boats and their component parts. For example, portable fish finders (including both thermometers and depth finders), outriggers, downriggers, rod belts, fishing chairs, and fishing harnesses are subject to the tax. The committee understands, however, that at the present time only outriggers of 10 feet or less in length, when extended, are used in recreational fishing; therefore, the committee anticipates that Treasury regulations will exempt from the tax (as items not used in recreational fishing) outriggers in excess of that length, unless present practice changes.

c. Payment of excise tax

The bill amends present law to require payment of these excise taxes on a quarterly basis as follows:

(1) March 31, in the case of articles sold during the quarter ending the previous December 31;

(2) June 30, in the case of articles sold during the quarter ending the previous March 31;

(3) September 24, in the case of articles sold during the quarter ending the previous June 30; and

(4) On a date prescribed in Treasury Department regulations in the case of articles sold during the quarter ending September 30.

The bill does not amend the time prescribed under present law for filing of returns of manufacturers excise taxes or the time for payment of such taxes on articles other than fishing equipment.

d. Transfer of excise tax revenues to Dingell-Johnson Fund

The revenues from the excise taxes on fishing equipment and from the tax on recreational fishing boats and boating equipment will be transferred to the Dingell-Johnson Fund, as under present law, for the purposes provided in that Fund.

e. Transfer of amounts equal to certain tariffs to Dingell-Johnson Fund

The committee bill provides for transfer to the Dingell-Johnson Fund of an amount equal to the import duties on fishing tackle collected under subpart B of part 5 of schedule 7 of the Tariff Schedules of the United States (19 U.S.C. 1202) and on yachts and pleasure craft under subpart D of part 6 of schedule 6 of those schedules.

Effective Dates

The amendments to the excise tax on fishing equipment and recreational boats apply to those items sold by a manufacturer or producer, or removed from bonded premises by an importer, beginning on the first day of the first quarter commencing after the date of enactment.

The amendments to the time for paying these excise taxes apply to articles sold after September 30, 1982.

The amendment transferring certain tariff and excise tax revenues to the Dingell-Johnson Fund is effective on October 1, 1982.

Revenue Effect

The net revenue gain is expected to be $23 million in fiscal year 1983, $35 million in 1984, $37 million in 1985, $38 million in 1986, $41 million in 1987.

5. Repeal of TAPS adjustment for the crude oil windfall profit tax (sec. 287 of the bill and sec. 4996 of the Code)

Present Law

Under present law, the windfall profit tax is a tax imposed on the windfall profit element of the price of domestically produced crude oil at the time taxable crude oil is removed from the premises from which it was produced. The tax is a percentage, ranging up to 70 percent, of the windfall profit earned on any barrel of taxable crude oil, but not in excess of 90 percent of the net income allocable to such barrel. The windfall profit equals the difference between the price of the oil and an adjusted base price, reduced by an adjustment for State severance taxes. The term taxable crude oil includes Sadlerochit oil, which is crude oil produced from the Sadlerochit Reservoir in the Prudhoe Bay oilfield. Most Sadlerochit oil is transported to the lower 48 states by way of oil tankers and the Trans-Alaska Pipeline System (TAPS).

Sadlerochit oil is taxable in tier one at a rate of 70 percent. The adjusted base price of such oil is, therefore, the controlled price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, reduced by $0.21, increased by an inflation adjustment. The removal price for any barrel of Sadlerochit oil is the deemed average removal price (sale price) for such oil for that calendar month.

Sadlerochit oil is subject to a special adjustment to its base price. Under this adjustment, the producer is allowed to increase the oil's adjusted base price for any quarter by the TAPS adjustment for that quarter, if any. The TAPS adjustment is the excess of $6.26 (the average cost of transporting a barrel of Sadlerochit crude oil through the TAPS in 1979) over the average per barrel tariff charged for transporting Sadlerochit oil through the TAPS in the preceding quarter.

The effect of this adjustment is to assure that downward adjustments in the TAPS tariff, which is subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC), do not result in increased windfall profit taxes on Sadlerochit oil. If the TAPS tariff falls, the removal price rises by an equal amount because the wellhead value of the oil will generally equal its value at the refinery minus the costs of transporting the oil from the wellhead to the refinery. The TAPS adjustment assures an equal, and offsetting, increase in the oil's adjusted base price.

There is no adjustment under present law for any upward adjustment in the TAPS tariff. If, therefore, the TAPS tariff rose above $6.26, thereby decreasing the deemed removal price (and windfall profit tax), no adjustment would follow.

Reasons for Change

The TAPS adjustment provides producers of Sadlerochit oil with a benefit given to no other oil producers under the windfall profit tax. The committee believes that this can no longer be justified at a time of budgetary stringency.

Explanation of Provision

The bill repeals the TAPS adjustment for Sadlerochit oil.

Effective Date

This provision is effective for oil removed after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $90 million in fiscal year 1983, $145 million in 1984, $154 million in 1985, $142 million in 1986, and $128 million in 1987.

H. Miscellaneous Provisions

1. Exclusion from income of National Research Service Awards (sec. 291 of the bill and sec. 161(b)(2) of the Revenue Act of 1978)

Present Law

Present law, subject to several limitations, provides that gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (sec. 117). In general, amounts received from scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future services for the grantor. However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the individual recipients agree to perform future services as Federal employees.

The amount excludable as a scholarship or fellowship varies depending on whether the individual recipient is or is not a candidate for a degree. In general, a degree candidate may exclude the entire amount of the scholarship or fellowship grant, unless any portion of the award is regarded to be payment for services in the nature of part-time employment. An individual who is not a candidate for a degree is limited to an exclusion of $300 per month for a period of 36 months.

In 1977, the Internal Revenue Service ruled that awards made under the provisions of the National Research Service Awards Act of 1974 to individuals who, in return for receiving the awards, must subsequently engage in health research or teaching or some equivalent service and must allow the Government to make royalty-free use of any copyrighted materials produced as a result of the research are not excludable scholarships or fellowhip grants.[1]

The Revenue Act of 1978 provided that amounts received as National Research Service Awards would be treated as excludable scholarships or fellowship grants under sec. 117. This provision was effective for awards made during calendar years 1974 through 1979. This treatment was extended to awards made in 1980 by Public Law 96-167 and to awards made in 1981 by Public Law 96-541, pending further study.

Reasons for Change

On three separate occasions, the Congress has provided on a temporary basis that National Research Service Awards should be treated as excludable scholarship or fellowship grants. The committee continues to believe that consideration should be given to a permanent rule regarding the Federal income tax treatment of National Research Service Awards. However, the committee has not yet been able to devote sufficient time to study this problem adequately. Accordingly, the committee has decided to extend the tax-exempt treatment of National Research Service Awards, pending further study.

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[1] Rev. Rul. 77-319, 1977-2 C.B. 48.

Explanation of Provision

The bill extends for two additional years (to awards made through the end of 1983) the exclusion for National Research Service Awards.

Effective Date

The provision applies to awards made in 1982 and 1983.

Revenue Effect

It is estimated that this provision will decrease fiscal year budget receipts by $1 million in 1982, $8 million in 1983, $7 million in 1984, $4 million in 1985, and $2 million in 1986.

2. Exemption from divestiture requirements of excess business holdings provision for the El Pomar Foundation (sec. 292 of the bill and sec. 101(*l*)(4) of the Tax Reform Act of 1969)

Present Law

The Tax Reform Act of 1969 imposed an excise tax on the excess business holdings of a private foundation (Code sec. 4943). Generally under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that, if a private foundation and disqualified persons together had holdings on May 26, 1969 in excess of the permitted amounts under the general rules, then those holdings could be retained for a transitional period during which the combined holdings have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold not more than 25 percent).

Reasons for Change

The committee believes that it is appropriate to provide an exemption from the divestiture requirements of the excess business holdings provision of present law with respect to ownership of the Broadmoor Hotel by the El Pomar Foundation of Colorado Springs, Colorado.

Explanation of Provision

Under the bill, the El Pomar Foundation of Colorado Springs, Colorado will not be required to divest itself of the interests which it held on May 26, 1969 (directly or indirectly) in the Broadmoor Hotel in order to avoid the excise taxes under section 4943 on excess business holdings. This exemption from the section 4943 divestiture requirements does not apply to any interests which may be held by the El Pomar Foundation in any business enterprise other than its direct or indirect holdings in the Broadmoor Hotel.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

It is estimated that this provision will have no effect on budget receipts through fiscal year 1987.

3. Exemption from divestiture requirements of excess business holdings provision for the Houston Endowment, Inc. (sec. 292 of the bill and sec. 101(*l*) of the Tax Reform Act of 1969)

Present Law

The Tax Reform Act of 1969 imposed an excise tax on the excess business holdings of a private foundation (Code sec. 4943). Generally, under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that if a private foundation and disqualified persons together had holdings on May 26, 1969 in excess of the permitted amounts under the general rules, then those holdings could be retained for a transitional period during which the combined holdings have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold no more than 25 percent).

Reasons for Change

The committee believes that it is appropriate to provide an exemption from the divestiture requirements of the excess business holdings provision of present law with respect to ownership of the Houston Chronicle Publishing Company by the Houston Endowment, Inc., of Houston, Texas.

Explanation of Provision

Under the bill, the Houston Endowment, Inc. of Houston, Texas, will not be required to divest itself of the interests which it held on May 26, 1969 in the Houston Chronicle Publishing Company in order to avoid the excise taxes under section 4943 on excess business holdings. This exemption from the section 4943 divestiture requirements does not apply to interests held by the Endowment in any other business enterprise other than its direct or indirect holding in the Houston Chronicle Publishing Company.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

It is estimated that this provision will have no effect on budget receipts through fiscal year 1987.

4. Debt Management Provisions

(Sec. 295 of the bill)

a. Rate of interest payable on the U.S. savings bonds

Present Law

The Secretary of the Treasury has discretionary authority to set the rate of interest on savings bonds within certain statutory limits. The Secretary, with the approval of the President, may increase the investment yield on any U.S. savings bond above the current rate in any six-month period by no more than 1 percentage point (annual rate; compounded semiannually). The authority to make such increases was intended to enable the Secretary to increase the rate of interest above the statutory limit and to keep the rate competitive with comparable alternative yields.

Series EE savings bonds now yield 9 percent (annual rate; compounded semiannually) when the bonds are held to maturity, which is now an 8-year period. The yield on Series HH bonds is 8½ percent; these bonds have a maturity of 10 years, with the interest paid semiannually by check. The Secretary used his discretionary authority to put these rates into effect on May 1, 1981. He has not exercised this authority since then. Series EE and HH bonds are not marketable securities.

No person may purchase more than $15,000 in Series EE bonds, at issue price, in any one year. The limit on purchases of Series HH bonds is $20,000 per year.

The income tax payment on the interest accruals on a Series EE or still outstanding Series E savings bond is deferred until the bond is redeemed.

Reasons for Change

The general increase in the structure of interest rates in recent years has resulted in a net increase of redemptions over sales of U.S. savings bonds. In the past 3 years, redemptions have exceeded sales by more than $25 billion. The Secretary's discretionary authority to raise the interest rate on savings bonds was used last on May 1, 1981, to raise the rates on Series EE bonds to 9 percent and to 8½ percent on Series HH bonds.

The Treasury Department did not use its authority to increase the rate on Series EE bonds to 10 percent on November 1, 1981, and it announced then that it would seek legislation to permit interest rates on savings bonds to be varied with current market rates. The Secretary has stated that increasing the savings bond rate might reduce the net redemptions, but it is an expensive alternative in the long run (because increases in savings bond interest rates have been applied to all outstanding savings bonds), if market interest rates decline.

Present statutory rules prescribe the frequency with which the interest rate on savings bonds may be increased. Recent experience with making frequent statutory adjustments in interest rates to keep savings bond yields reasonably competitive with the yields on comparable private alternatives has been unsatisfactory. The committee, therefore, concurred in the Administration request for authority to relate the savings bond yields to current market rates.

Explanation of Provision

The committee bill provides that the Secretary of the Treasury, with the approval of the President, may fix the investment yield on any United States saving bond. The Secretary also would be authorized to provide for increases and decreases in the yield on any outstanding United States savings bond. With this authority, the Secretary, however, may not decrease the yield on any bond for the period it is held below the minimum yield that was guaranteed for such period at the time of its issuance or at the time the bond entered an extended maturity period.

Although the committee action does not endorse any specific plan that may be used in setting yields on savings bonds, the committee noted a possible plan that Treasury described during a public hearing on April 27, 1982.

Under the plan, the Secretary would issue U.S. savings bonds that could assure long-term savers that the rate on savings bonds would continue to be competitive with current market rates. The new bonds could be issued with ten-year maturities. During the first five years, the yield would be increased at six month intervals and the yield earned at the end of the five year period would be the guaranteed minimum rate for the remaining years to maturity. The minimum yields that would be guaranteed for each accrual period during the ten years would be expressed in terms of the prescribed redemption values of the bond. After the first five years, the yield on the bond during any accrual period could be as high as 85 percent of an average of current yields on marketable five year notes but no less than the yield implied in the guaranteed redemption values.

The rate paid on savings bonds would be less than the full marketable rate for several reasons: (1) savings bonds are available in smaller minimum denominations than Treasury marketable debt issues and therefore entail higher administrative costs; (2) savings bonds have tax deferral advantages which increase their effective yield after taxes (relative to marketable securities); and (3) savings bonds are redeemable at fixed values, thereby eliminating the risk of market value depreciation inherent in ownership of marketable Treasury notes. On this basis, a rate on savings bonds equal to 85 percent of the rate on marketable Treasury five-year notes is considered to be a fair rate of return.

The initially low guaranteed yield and small increase for each subsequent accrual period would be designed to make the savings bonds attractive to relatively small investors with long time perspectives. These individuals would be expected to focus primarily on the guaranteed yields and redemption values and the assurance of higher yields if held for five years or more: As a result, savers with shorter-run objectives should find savings instruments available from savings and loan associations, commercial banks, and comparable other institutions more attractive than the new Treasury issues.

The committee intends that all references in the Second Liberty Bond Act to series E and H savings bonds should be considered as generic references to all United States savings bond series.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision has no direct effect upon the level of budget receipts.

b. 4¼ percent limit on interest rate on bonds

Present Law

Obligations of the United States are defined as bonds if they have a maturity when issued that is longer than 10 years. The rate of interest that may be paid on a bond may not exceed 4¼ percent, except that up to $70 billion in outstanding bonds with rates of interest above 4¼ percent may be held by the public. The exception for a specified amount of bonds—initially $10 billion—was enacted in 1971, and it applied to all bonds with rates above the ceiling. An amendment in 1973 applied the $10 billion limitation only to bonds held by the public, i.e., holdings of Federal agencies and the Federal Reserve were not included. The last increase in the limit was enacted in October 1980, and it raised the limit from $54 billion to $70 billion.

Reasons for Change

The Treasury Department has exhausted its $70 billion authority to issue long-term bonds and was forced to cancel its regular quarterly issues of 20-year bonds in April and 30-year bonds in May. The last bond auction was held in February 1982, and it required an interest coupon of 14 percent.

The Treasury Department believes it must continue to issue bonds to maintain a presence in all maturity sectors of the bond market and to resist shortening the maturity of the public debt. About half of the privately held marketable debt matures in one year and two-thirds within 2 years. The average maturity was 4 years at the end of April 1982.

The inability of the Treasury Department to continue the quarterly bond cycle may also disrupt the bond market. Disruption would occur because of market uncertainty about Treasury plans and how to allocate investable funds among private and public issues and among different maturities. In addition, the Treasury Department believes that maintaining a stable bond market reduces borrowing costs in the long run, even though the interest rate when a bond is issued may be high in terms of historical patterns.

The committee did not agree with the Treasury Department that this is the appropriate time to repeal the interest rate limitation on bonds. On the other hand, the committee did not believe that the Treasury Department should be proscribed from participating in the long-term bond market.

Explanation of Provision

The committee approved an additional $40 billion increase in the exception from the interest rate ceiling; this action raises the exception to $110 billion. The Treasury Department will be able to continue to operate in the long-term bond market for about two years with this authority, if it continues its long-term bond debt management practices of the past few years.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision has no direct effect upon the level of budget receipts.

5. Study of alternative tax systems (sec. 296 of the bill)

Present Law

Studies of particular parts of the Internal Revenue Code or of alternative tax mechanisms are not mandated in present law. However, one of the duties of the Joint Committee on Taxation is to investigate the operation and effects of the Federal system of internal revenue taxes, including measures and methods for the simplification of such taxes (sec. 8022). The Joint Committee published a report on income tax simplification in 1977 in response to the requirement for the study in the Tax Reform Act of 1976 (sec. 507; P.L. 94-455).[1]

Reasons for Change

The committee believes that the current system of income taxation is unduly complex. The large number of tax preferences and special deductions, credits and exclusions increase compliance and administration costs, and undermine the taxpayers' confidence in the fairness of the Internal Revenue Code. Non-uniform taxation distorts individual and corporate economic decisions, thereby lowering economic efficiency. For these reasons, it is desirable to study the effects of a more comprehensive tax base. Broadening the base also would allow a reduction in marginal rates, which would increase the incentive to work and invest. The committee believes that alternatives which increase the simplicity, efficiency and fairness of the tax system should be carefully studied.

Explanation of Provision

The bill requires the Secretary of the Treasury to conduct a study of the advisability of replacing (1) only the Federal individual income tax and (2) both the Federal individual income tax and the Federal corporate income tax with an alternative tax system. For this purpose, an alternative tax system means a system based on (1) a simplified income tax based on gross income, (2) a consumption tax, (3) a percentage tax on consumption, or (4) the broadening of the base and lowering the rates of the current income tax system.

The study is to consider the administrative complexity of the existing Federal income tax system and to address the ramifications of replacing the existing system with an alternative system. The Treasury would be required to submit a report to the Senate Committee on Finance and the House Committee on Ways and Means not later than 6 months after enactment of the bill.

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[1] "Issues in Simplification of the Income Tax Laws," JCS-57-77, September 19, 1977.

6. Study on monetary policy (sec. 297 of the bill)

Present Law

The conduct of monetary policy, including the determination of monetary targets and variables, is performed by the Federal Reserve System.

Reasons for Change

The committee is concerned that the Federal Reserve may not be studying a sufficiently wide range of alternative ways of conducting monetary policy. The committee is interested in changes in monetary policy targets which would restore stability to capital markets, lower real interest rates, and reduce the impact of the federal deficit on credit markets.

Explanation of Provision

This bill instructs the Secretary of the Treasury to submit to the tax-writing committees, no later than 6 months from the date of enactment, a study of the effects on capital markets of using a measure for the growth of debt as the long-term target of monetary policy, and a measure of total liquid assets as an interim target of monetary policy.

The measure of the growth of debt should be a "debt proxy," defined as the sum of credit market instruments, deposits and currency held by private domestic nonfinancial investors.

The study is to:

(1) assess the feasibility of using the "debt proxy" as the target of monetary policy; and

(2) assess and compare the effect of using the "debt proxy" versus the money supply, as currently defined, as the target of monetary policy on—

(a) the level and stability of rates of interest on capital;

(b) the risk to customers holding variable interest rate obligations;

(c) the concentration of financial institutions through mergers and consolidations;

(d) the price of alternative credit maturities available to business;

(e) the ability of capital markets to reliquify credit during periods of business contraction and early business recoveries;

(f) the ability of monetary policy to adjust rapidly to accelerated financial innovation; and

(g) the ability of monetary policy to achieve a closer association between monetary targeting and the Gross National Product.

Effective Date

This provision is effective on the date of enactment.

7. New Jersey revenue sharing allocation (sec. 293 of the bill)

Present Law

The general revenue sharing program was established under the authority of the State and Local Fiscal Assistance Act of 1972 (Public Law 92-512) and was extended with modifications by the State and Local Fiscal Assistance Amendments of 1976 (Public Law 94-488). The program was further extended, with modifications in the ability of State governments to qualify for funds, by the State and Local Fiscal Assistance Amendments of 1980 (Public Law 96-604). The 1980 Amendments provide for payments to units of local government in the amount of $4,566,700,000 for each of the fiscal years 1981, 1982, and 1983.

Under present law, revenue sharing funds are distributed to units of local government based on a formula that allocates funds to a geographic area within a State and provides for the division of those funds among the units of local government within that area. One of the factors taken into account in allocating general revenue sharing funds is the tax effort of the units of government that are eligible for funds.

Reasons for Change

In general, a tax must be assessed and collected by a qualifying unit of government in order for that tax to be counted toward the jurisdiction's tax effort. The New Jersey Franchise and Gross Receipts Tax, prior to 1980, was assessed and collected by units of local government. It has come to the attention of the committee that in 1980 the New Jersey legislature amended the Franchise and Gross Receipts Tax to provide for its assessment and collection by the State, with the proceeds of the tax made available for use by units of local government. Under the State and Local Fiscal Assistance Amendments of 1980, this change by the New Jersey legislature would preclude consideration of the Franchise and Gross Receipts Tax as an adjusted tax of units of local government for purposes of allocating revenue sharing funds within the State of New Jersey. The committee concluded that this change could have a disruptive effect on the pattern of revenue sharing payments to units of local government in New Jersey. Accordingly, the committee agreed to a provision that will preserve the present formula for distributing those funds with respect to the classification of the Franchise and Gross Receipts Tax for a brief period of time, in order to allow the State of New Jersey to decide whether to convert the Franchise and Gross Receipts Tax back to an adjusted tax of units of local government. The committee does not intend by its action to express a judgment as to the appropriate classification for the Franchise and Gross Receipts Tax, but simply intends to allow the

State of New Jersey a brief period of time in which to take the initiative to correct this problem if it deems such action appropriate.

Explanation of Provision

The bill provides that, with respect to the quarterly revenue sharing payment to be made with respect to the quarter beginning on October 1, 1982, the New Jersey Franchise and Gross Receipts Tax shall be deemed an adjusted tax of units of local government for purposes of allocating revenue sharing funds to units of local government in New Jersey. However, the Franchise and Gross Receipts Tax shall be deemed an adjusted tax of units of local government in New Jersey for purposes of future quarterly revenue sharing payments only if, prior to January 1, 1983, the Governor of the State of New Jersey notifies the Secretary of the Treasury that, prior to January 1, 1983, the State amended the New Jersey Franchise and Gross Receipts Taxes statute to provide for collection and retention of such taxes by units of local government for years beginning as of January 1, 1983. Without such action by the Governor of the State of New Jersey, the Franchise and Gross Receipts Taxes would cease to be deemed an adjusted tax of units of local government quarterly payment periods beginning after December 31, 1982.

Effective Date

The amendment made by the provision is effective after September 30, 1982.

Revenue Effect

This provision has no effect on budget receipts.

8. Relief for the Jefferson County Mental Health Center, Lakewood, Colorado (sec. 298 of the bill)

Present Law

Under present law, employees of a nonprofit organization are excluded from social security coverage unless the organization files with the Internal Revenue Service a certificate waiving its exemption from taxation. Employees of the organization at the time the waiver certificate is filed are given the option to participate in the program and, if they decide to do so, must sign a form accompanying the certificate waiving their right of exemption. All employees subsequently hired by the organization are automatically covered under the program.

Reasons for Change

The committee understands the facts of the situation to be as follows. The Jefferson County Mental Health Center, Inc. (the "Center"), an exempt organization described in section 501(c)(3), filed a waiver certificate in 1963 pursuant to section 3121(k)(1)(A), by which the Center waived the exemption for payment of social security (FICA) taxes. In accordance with that filing, the Center began deducting the employee portion of FICA and paid that portion, along with its portion, to the Internal Revenue Service.

As a result of a mistaken response by the Center to a questionnaire circulated by the Internal Revenue Service, the Western Region Service Center of the Service at Ogden, Utah, mistakenly notified the Center by letter dated February 28, 1975, that the Center was not liable for the FICA taxes. As a result of that letter, and follow-up instructions received by telephone from the Service, the Center contacted those persons whom they were able to locate who had been employed by the Center (133 in number), during the calendar years 1972 through 1974, and each of those individuals was offered an election as to whether or not he or she wished to be covered over the prior 3 years (1972 through 1974) and in the future under FICA.

Of those contacted, 103 elected not to be covered by FICA, and to those 103 employees and former employees, the Center paid out $74,128 from its own funds as refunds covering contributions by and for them to FICA over the 3 years (1972, 1973, and 1974). Those employees unable to be contacted were treated as though they had elected to be covered. No refunds were made to those employees nor to those who elected to remain covered (a total of 30 in both categories). This action was taken due to assurances by the Internal Revenue Service that a prompt refund would be made to the Center of the employees' tax and the tax the Center had paid, once refunds had been advanced by the Center out of its own funds to those employees.

After the Center had paid the employees $74,128, the Western Region Service Center, on May 14, 1975, notified the Center that the Service had found a valid waiver certificate on file, and that neither the refunds nor the employees' electons should have been made.

Those employees who elected not to be covered by FICA and who remained employees of the Center after January 1, 1975, have been treated by the Center as continuing not to be covered by FICA in accordance with their election made pursuant to the Service's instructions arising out of the February 28, 1975, letter.

The Service has advised the Center that there is no provision in law which would authorize administrative relief for the action which the Center has taken in reliance on the letter from the Service of February 28, 1975.

As an equitable matter for the relief of the Center, the committee has agreed to a provision to compensate the Center in full settlement of all claims arising out of the erroneous advice of the Internal Revenue Service to the Center that the contributions had been incorrectly withheld.

Explanation of Provision

The provision authorizes the payment of $50,000 to the Jefferson County Mental Health Center in full settlement of its claims against the United States for repayment of the $74,128 the Center refunded to its employees for individual social security contributions after the Internal Revenue Service erroneously advised the Center that the contributions had been incorrectly withheld. The bill also provides that no part of this $50,000 in excess of 10 percent shall be paid out for services rendered in connection with this claim.

Effective Date

The provision is effective on enactment.

Revenue Effect

The provision authorizes a single payment of $50,000. There would be no direct effect on budget receipts.

V. COSTS OF CARRYING OUT THE REVENUE PROVISIONS OF THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of H.J. Res. 4961, as reported.

The table below summarizes the estimates of the net increases in budget receipts from the tax provisions of the bill for fiscal years 1982–1987. The estimates are presented in greater detail in Section III of this report, Budget Effects of Revenue Provisions.

SUMMARY REVENUE EFFECTS OF TAX PROVISIONS

[In billions of dollars]

Provision	Fiscal year—					
	1982	1983	1984	1985	1986	1987
Individual income tax provisions		240	2,984	3,251	3,548	3,856
Provisions primarily relating to business	175	5,927	12,755	18,162	30,559	42,262
Compliance provisions		6,698	7,056	8,646	10,115	11,112
Pension provisions		211	588	673	762	848
Life insurance and annuities	489	1,487	1,510	2,183	2,935	3,167
Employment taxes		1,814	3,104	3,869	4,012	3,862
Excise tax provisions		2,509	3,847	4,734	4,873	4,929
Miscellaneous provisions	−1	−38	−37	−34	−32	−30
Total tax provisions	**663**	**18,848**	**31,807**	**41,494**	**56,772**	**70,006**

SUMMARY REVENUE EFFECTS OF TAX PROVISIONS—Continued

[In billions of dollars]

Provision	Fiscal year—					
	1982	1983	1984	1985	1986	1987
Revenue gain from additional IRS enforcement personnel		2,100	2,400	2,400	1,300	600
Grand Total, All Provisions	663	20,948	34,207	43,894	58,072	70,606

NOTE.—Details may not add to totals due to rounding.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 4961, as amended, was ordered favorably reported by a rollcall vote of 11 ayes and 9 nays.

VI. REGULATORY IMPACT OF THE REVENUE PROVISIONS OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of this bill.

Numbers of individuals and businesses who would be regulated

The bill does not involve new or expanded regulation of individuals or businesses.

Economic impact of regulation on individuals, consumers and businesses

The bill does not involve economic regulation. Many provisions of the bill, however, will reduce the opportunities to avoid taxation and to fail to comply with the tax laws. Other provisions decrease the tax benefits available through various credits and deductions. The net effect of the changes will be to decrease the role of government and to increase the role of capital markets in determining the allocation of investable funds among business activities.

Impact on personal privacy

This bill does not relate to the personal privacy of taxpayers.

Determination of the amount of paperwork

The bill generally will not affect the current amount of paperwork for most taxpayers. The requirements for information reporting on payments of income will increase paperwork for some payors, but the net effect will be an increase in taxpayer compliance and tax receipts.

B. Other Matters

Consultation with Congressional Budget Office on budget estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates of the tax provisions of the bill (as shown in Section III of this report) and agrees with the methodology used.

The views of the CBO with respect to the budget effects of the revenue provisions in H.R. 4961 were not available when the report was filed. A statement with CBO estimates will be made available subsequently.

New budget authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill creates new budget authority under the provisions relating to the Airport and Airway Trust Fund, the increased revenues from increased excise taxes on fishing and boating equipment that will be made available to the Dingell-Johnson recreation fund, and increased revenues to be appropriated to the Unemployment Trust Fund. The bill also includes an authorization for the appropriation of additional funds for administrative purposes for the targeted jobs tax credit program.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee makes the following statement.

Tax expenditures will be decreased by virtually all the income tax sections of the bill, since they reduce the tax benefits currently available from credits, deductions or exclusions, and increase reporting and compliance requirements. Tax expenditures will be increased by shortening the holding period from 12 months to 6 months to qualify for long-term capital gains treatment, the extension of the targeted jobs tax credit, and the extension of the exclusion from income for National Research Service Awards for an additional two years.

The estimated effects on budget receipts of tax expenditure changes is presented in Section III of this report, Budget Effects of Revenue Provisions.

VII. CHANGES IN EXISTING LAW MADE BY THE REVENUE PROVISIONS OF THE BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the revenue provisions of H.R. 4961, as reported by the committee).

VIII. ADDITIONAL VIEWS OF SENATOR ROBERT J. DOLE

The budget reconciliation legislation we have agreed to in the Finance Committee strikes a proper balance, in both spending and revenues, between the need to reduce the deficit and the goal of spreading the burden of deficit reduction fairly. The program changes and revenue increase provisions of this bill have been chosen with a view to making policy adjustments that are sound and sensible, and that would be desirable even in the absence of the need to reduce the deficit. That is as it should be, and I trust that the Senate will give strong support to ratifying the decisions of the Finance Committee.

On the revenue side of the ledger, we have sought to eliminate unjustified preferences in the tax code and improve compliance with present law: in other words, to broaden the tax base and make the present system more efficient before turning to new revenue sources. This is the way we ought to proceed, in light of last year's action to reduce and stabilize tax rates and lighten the corporate tax burden. The days of automatic tax increases are past—our focus has to be on inequities and unnecessary complexity in the tax code.

I believe this is a very good bill, but I do not claim that it is perfect. Some of us would have preferred to make a more moderate adjustment in the deductions for medical expenses. It is certainly true that modifying these provisions is appropriate if we are to begin the process of moving toward a simplified tax with lower rates, as many would prefer. At the same time, we do not want to disregard the long-held principle that tax burdens should bear a relation to the taxpayer's ability to pay. This is certainly a matter we have to take account in connection with unpredictable or unavoidable medical expenses. The 10-percent floor that we have agreed to may cause hardship in some cases, and I intend to seek an appropriate opportunity, on the Senate floor or in conference if necessary, to modify this provision consistent with our revenue targets to ease its impact somewhat.

I have a somewhat similar concern with respect to the low-income exemption from withholding on interest on dividends. As agreed to by the committee, this exemption protects only those who have no tax liability. It may be appropriate to broaden the exemption somewhat to cover taxpayers with a minimal tax liability. Our goal is not to penalize the small saver, after all, but to pick up those taxpayers who have been evading tax. Provided that we can agree upon an appropriate cut-off point for minimal tax liability, I will also move at the proper time to expand the low-income exemption. I believe this can be done consistent with our revenue targets.

This is a good bill. The changes I have discussed can make it better, but it deserves the full support of the Congress.

ROBERT J. DOLE.

IX. ADDITIONAL VIEWS OF SENATOR BOB PACKWOOD

One of the philosophic underpinning of the Administration's budget for fiscal year 1983 is increased reliance on user fee financing for government programs which benefit indentifiable classes of users. One of the commendable aspects of the bill now being reported is that it puts a test before the Senate with respect to one important user fee area—the Airport Development Aid Program (ADAP).

The bill being reported to the Senate includes increases in the user taxes which are available to finance ADAP. In addition, at the request of the Commerce Committee, the bill also includes the Airport and Airways System Development Act. These substantive provisions are, of course, solely in the jurisdiction of the Commerce Committee. However, including those provisions in this bill squarely puts the user fee philosophy before the Senate.

The most important aspect of the user fee philosophy is that the user fees and taxes are to be allocated to programs which benefit the persons paying the user fees. The ADAP package in this bill achieves this. However, one additional provision is needed to ensure that aviation user taxes are spent on the airport development program. On behalf of the Commerce Committee, I will offer and amendment to include this provision when this bill is on the Senate floor.

The amendment which I will offer provides a trigger to tie the aviation user taxes to spending for the airport development program. Specifically, the trigger will provide that if, in any fiscal year, the funds made available by the Congress for obligation under the airport development program are less than 85 percent of the authorized levels, then aviation user taxes and spending authority or the FAA's budget except for the airport development program, will terminate at the end of that fiscal year.

I believe that the trigger should be included as a part of the ADAP bill. It is incompatible with the user fee philosophy to continue raising aviation user taxes if the revenues are not being spent for the airport development. The integrity of the user fee approach exists only if the revenues are spent on the airport development program.

Bob Packwood.

X. ADDITIONAL VIEWS OF SENATOR MALCOLM WALLOP

STATEMENT OF SENATOR MALCOLM WALLOP REGARDING THE SYMMS AMENDMENT ELIMINATING ALL HARD ROCK MINERALS, EXCEPT FOR COAL AND IRON ORE, FOR THE 15 PERCENT REDUCTION IN THE PERCENTAGE DEPLETION ALLOWANCE

As originally proposed by the Finance Committee, the Corporate Minimum Tax Preference Reform segment of the Finance Committee package called for certain corporate tax preference items to be reduced by 15 percent. Included in that list of preference items was the percentage depletion allowance for hard rock minerals. During the course of the Finance Committee's mark-up of the tax package, concern was expressed as to the adverse affects of a 15 percent reduction of the percentage depletion allowance on the currently depressed mining industry. In recognition of that concern, representatives of the Joint Committee on Taxation, the Senate Finance Committee, the Treasury Department, and Senator's personal staffs, including my own, began to work toward a resolution of the problem.

The only general agreement which was acceptable to the majority of those representatives and the Members, was that the 15 percent reduction of the percentage depletion allowance would be eliminated, with the exception of coal and iron ore production. That proposal was offered to the Committee by Senator Symms and accepted. While I supported the thrust of that amendment and believed it was the right course of action, I felt compelled to vote against the amendment because I did not feel it went far enough. Coal and iron ore production should have been exempted from the reduction in the depletion allowance as well. It is no secret in the State of Wyoming, or the rest of the country, that those segments of the mineral industry are feeling many of the same affects as have been experienced by the silver and uranium industry. The proper treatment which was extended to other hard rock minerals should have also been extended to coal and iron ore.

MALCOLM WALLOP.

XI. ADDITIONAL VIEWS OF SENATOR WILLIAM L. ARMSTRONG

For most of this year, cynics have predicted failure for efforts to cut spending, curtail growth of entitlements and raise revenue. After all, they said, this is an election year.

The prevailing wisdom has been that the Senate Finance Committee—with six Senators up for reelection—could not vote to reduce entitlements or raise $100 billion in revenue for the next three years as required by the most recent budget resolution. Over and over again, it was predicted that when push comes to shove, the Finance Committee would either not report a bill, or worse, recommend repeal of the third year of President Reagan's 25 percent tax reduction program.

Well, the cynics were wrong. Under the skillfull leadership of Chairman Bob Dole, the Finance Committee has fulfilled its mandate under the budget resolution by recommending a bill which:

> Reduced spending in the Aid to Families with Dependent Children, Supplemental Security Income, Medicare and Medicaid entitlement programs by $18 billion in the next three years.
>
> Achieved entitlement savings by reasonable structural changes in programs and not by meataxe, callous wholesale reductions in benefits or eligibility. For example, the committee reduced federal subsidies for administrative errors, required benefits to be paid on the date of eligibility and not before, made uniform reimbursement schedules for all Medicare service providers, ended AFDC benefits for those who refuse to work or reject a bona fide job offer, and other similar reforms.
>
> Meets the budget resolution revenue targets without repealing, delaying or modifying the third year personal income tax cut or otherwise undermining the basic principles of the historic supply-side tax reductions enacted last year.
>
> Closes a loophole that permitted some defense contractors to pay little or no taxes on record earnings.
>
> Closes another loophole used by the insurance industry to escape taxation, and at the same time modernized antiquated tax laws governing the industry.
>
> Partially ends another loophole in which business received double tax benefits for new equipment purchases.
>
> Authorizes the taxes and finances the spending necessary to update the nation's airports and airways.
>
> Increases taxpayer compliance at a time when $40 billion in federal revenue remains uncollected because of tax evasion.
>
> Makes critically needed reforms of overly generous provisions permitting corporations to "sell" unused tax benefits.
>
> Scales back provisions permitting some corporations to defer tax payments for as long as 10 years.

Provides guidelines for financing of "private purposes" with industrial development bonds . . . whose sheer volume in recent years threatens the ability of state and local governments to raise the money necessary to build critically needed roads, sewers and schools.

Does not raise energy taxes.

On the whole, the bill is a worthy response to the reconciliation instruction of the Congress contained in the recent budget resolution. Putting together such a comprehensive and important legislative proposal in a very brief time, less than two weeks following adoption of the budget resolution, is a tribute to the extraordinarily strong and patient leadership of Senator Dole. I also want to express my admiration and appreciation to the committee staff whose faithfulness, painstaking attention to detail and expertise are truly commendable.

At the same time, however, I want to explain that the only reason that I am personally willing to support the tax provisions of this bill is in consideration of the spending reductions it contains and other spending restraints mandated by the budget resolution. The nation's drastic economic problems, caused by two decades of gross fiscal irresponsibility, urgently require reduction of federal budget deficits at the earliest possible time and a balanced budget within the near future. Although I personally feel that the budget resolution does not go far enough toward deficit reduction, it offers the best available prospect for achieving fiscal integrity and, thereby, restoring the nation's economic health. Under the circumstances, I feel obligated to support certain parts of the budget "package" which would otherwise be anathema. I therefore intend to support the bill recommended by the Finance Committee.

But there is at least one serious omission in the legislation as reported by the committee and other provisions which I feel should be changed.

CAPITAL GAINS INDEXING

By a vote of 11-9, the committee declined to adopt my amendment to provide for indexing the capital gains tax. Had the committee approved this amendment it would have taken the first step necessary to end the current inflation tax imposed on capital.

Under current law, a capital gains tax is applied on a portion of the increased value of an asset at its sale. While assets held for several years usually increase in value, the increase is largely because of inflation. In other words, the capital gains tax now imposed is not a tax on real gain, but on inflation gain.

My amendment removes the inflation tax by adjusting the basis of certain assets for inflation, using the GNP deflator. The inflation adjustment is the percent of increase in inflation, as measured by the GNP deflator, from the time of purchase of the asset, or enactment of this legislation, and the time it is sold. As a result, the capital gains tax will only apply to real gain, and not inflation gain.

To reduce complexity, the amendment applies only the corporate stock and real personal property that has been sold or exchanged, and does not apply for purposes of determining depreciation, cost depletion or amortization. Debt is completely excluded from the inflation adjustment. The inflation adjustment can be used to index assets for determining corporate earnings and profits.

This amendment is identical to legislation overwhelmingly adopted by the House of Representatives in the 95th Congress. Despite the amendment's popularity and common sense, it was not considered by the Senate.

This amendment corrects a serious impairment in capital formation so necessary to get our economy moving again. The National Bureau of Economic Research reported that in 1973 alone $4 billion in capital gains transactions occurred and were, subject to a capital gains tax of $1.1 billion. Had these assets been adjusted for inflation, there would not be any gain . . . in fact, the capital losses would have exceeded $1 billion. In other words, the current capital gains tax prevents the sale and exchange of property, and the subsequent freeing of capital for other investments. We have so rigged the tax code that capital is unfairly taxed.

Since this amendment is critically needed, the Senate Finance Committee and the Senate will have another opportunity to consider the merits of this legislation.

SAFE HARBOR LEASING

To the uninitiated, safe harbor leasing—new to the American vocabulary—may invoke visions of a rented yacht anchored restfully on placid waters.

Far from it. Safe harbor leasing is far and away the most stormy tax issue of the day. Originating from last year's tax cut law, safe harbor leasing refers to provisions removing all previous restraints on corporate equipment leasing transactions. It permits cash-starved corporations to sell their unused tax credits to other firms needing tax deductions to reduce their tax liability. The stakes are incredibly high . . . safe harbor leasing could affect as much as $150 billion in new plant and equipment purchases over the next six years, and $30 billion in federal revenue.

Without safe harbor, some firms will cancel huge equipment purchases, and others may be forced into bankruptcy. But retaining safe harbor will certainly disadvantage some firms . . . possibly also to the point of bankruptcy.

With so much at stake, the battle lines were drawn soon after Congress enacted safe harbor a year ago. The pitched battle is between those who believe safe harbor is the only lifeline keeping the auto, steel, airline and other economically distressed industries in business and those who argue that safe harbor is nothing more than corporate food stamps.

The battle came to a head last week during Finance Committee action on the Tax Equity and Fiscal Responsibility Act of 1982. The result is a compromise which eliminates the most objectionable features of safe harbor leasing.

But the reform does not repeal safe harbor outright and therefore falls short of what should be done. Like many in Congress, I share the conclusion of Dr. Alan Greenspan, once Chairman of the President's Council on Economic Advisors, that this leasing "is the equivalent of food stamps for undernourshed corporations."

Safe harbor leasing should be repealed. Safe Harbor—

Has been significantly abused.

Subsidizes unprofitable investments.

Discriminates against small businesses, and start-up businesses relying on used equipment.

Will only be expended in horrendous ways unless curtailed now.

Distorts the neutrality of tax laws.

Diverts investment toward depreciable assets, and away from such vitally necessary investments as new and patentable technology, research, and energy exploration.

Promises to be a huge budget buster in later years.

Is an inefficient use of capital.

Undermines taxpayer confidence in the fairness and equity of the tax system.

Undermines more promising and efficient efforts to assist American business—large and small—to prosper, flourish and remain profitable.

To understand fully why safe harbor leasing merits repeal requires a review of past and present tax policy and theory, as well as grasping the future consequences of safe harbor leasing. Equally important is the transformation in public opinion about private enterprise, and how safe harbor undermines the currently healthy American attitude toward profitable businesses.

Private business is now basking in new found public popularity. Americans now believe in the necessity of capital formation, thrift, productivity, and profit. This is reflected in public opinion polls, skyrocketing enrollment in college business schools, and union wage concessions that improve the bottom line.

It has not always been that way. The 1970s saw public attitudes about successful enterprises sour. "Capitalistic pigs", "price gougers" and "obscene profits" were the popular catch words. An anti-business attitude emerged in the nation and was reflected in Congress. Americans elected policy makers advocation wage, price and credit controls, punitive tax rates, heavy government regulation of business, enforced corporate social responsibility, government job creation programs, and other nonsensical endeavors.

This anti-business attitude—and its attendant laws, regulations and judicial findings—took its toll. Government regulation eroded profitability . . . to the point where just one company, Chrysler Corporation—one of the companies who now look to safe harbor leases to generate desperately needed cash—spends $160 million monthly in regulation compliance. Profits as a percent of the Gross National Product nosedived 50% in a decade. Key indicators of the nation's economic vitality faltered. Plant modernization was deferred, productivity slipped, patented technology declined, the stock market stagnated, bankruptcies proliferated while taxes and inflation eroded company profits and worker paychecks.

But the public opinion began to change when the anti-business policies led to the inevitable result of fewer jobs, inability to compete against foreign firms and a decline in modernization and productivity. A new appreciation for the business world began to emerge. Belatedly, Congress realized that new economic policies were needed to get business moving again.

President Reagan reflected this conviction, and last year persuaded Congress to enact his economic recovery tax program. It cut individual and business taxes across the board, and provided economic incentives for new plant and equipment purchases.

But that plan as amended by Congress went too far. By enacting safe harbor leasing Congress sanctioned a near panic effort to assist, at almost any cost, large businesses regardless of their profitability. Just as the Congressional pendulum once swung too far against the interests of business, it now swings too far in the direction of bailing out big business. A backlash is in the works and could undermine the healthy new respect for enterprise, ingenuity and profit . . . underscored by such headlines as "Attempt to Cut Poor Firms' Taxes Allow Rich Ones to Pay No Taxes" and "The Great Business Giveway" and "New Tax Game the Big Guys Play".

Headlines, like appearance, are often deceiving. Corporate America does not consist of wholesale tax evaders. But like any other taxpayer, corporations have the right, even the duty, to do all they legally can to minimize their tax liability.

That is exactly what large American businesses are doing with safe harbor leasing. They are exploiting—in ways not contemplated by Congress—overly generous and misguided leasing provisions.

In essence, safe harbor is a tax benefit transfer mechanism, pure and simple. Safe harbor allows corporations to sell their unused tax credits to other firms that need tax deductions to reduce their corporate tax liability. Safe harbor leasing is a true bonanza for big business. Consider the following—

> General Electric used safe harbor leases so effectively that it received a tax *refund* of $150 million . . . even though it had income of $1.65 billion. GE strongly supports repeal of safe harbor, saying it simply cannot be justified.
>
> Amoco, Inc. bought $417 million in safe harbor leases, and cut its taxes substantially while reducing wildcat exploration 20% because of a "tax induced capital shortage."
>
> Occidental Petroleum had total *earnings* of $710 million, but paid no taxes in part because safe harbor leases preserved foreign tax credits it had received for oil payments made in part to Libya.
>
> The New York Transit Authority—even though tax-exempt—used safe harbor leasing last year because of a special exemption written into law. The leases were used to buy foreign manufactured subway cars. The middlemen received a tidy profit . . . $1 million on the total $15 million transaction.

These are the horror stories showing the consequences of safe harbor leasing. But these are only part of the story. Safe harbor is big business. Since August, $17.4 billion in equipment has been leased under the new rules, and the transfer of unused tax benefits reduced federal revenue by $4 billion. By 1987, the total revenue loss could easily exceed $30 billion on leases worth $150 billion.

I want to stress that I do not criticize these companies or any others which have taken advantage of the safe harbor leasing provisions. They are perfectly justified in doing so. Every taxpayer is required to fully comply with provisions of law which are to the taxpayer's disadvantage and has, in my opinion, a corresponding right to fully utilize favorable tax code sections. What I do criticize is the law itself.

But political perception, horror stories and sheer volume alone are not enough to justify repeal of safe harbor leasing. What is safe harbor leasing, how does it work and can the tax principle it represents be justified?

BACKGROUND ON THE LAW PRIOR TO SAFE HARBOR LEASING

Only taxpaying property owners can claim depreciation deductions and investment credits. Companies that pay no taxes may not claim these tax benefits.

As a result, nontaxable companies rent equipment from taxable companies that can benefit from tax deductions and credits. This produces lower taxes for the company owning the property, and lower rental fees for the company leasing the equipment. Equipment leasing is a major means of providing equipment users with capital equipment. In 1981 alone, $40 billion in capital equipment was leased.

But there is a potential tax abuse in these leasing arrangements, and it depends on whether a particular arrangement is actually a lease, or merely a case of the nominal owner just financing the equipment that is used and essentially owned by the company paying no taxes. If the IRS determines that the arrangement is truly a lease, then the lessee can deduct the rental payments as a business deduction, and the lessor can deduct the depreciation and claim investment tax credits. If the arrangement is merely a financing transaction and the lessee is the true owner of the property, then only he can deduct the depreciation and claim investment tax credits.

The determination of a lease often is done on a case-by-case basis relying on three past IRS rulings. Essentially, five requirements must be met that insure the lessor has an equity investment in the lease, will profit from the lease independent of the tax benefits and that the lessee does have a direct financial investment interest in the leased property.

REASONS FOR CHANGE

Under the old law, corporations losing money (and, therefore, paying no taxes) could not fully benefit from depreciation deductions. These unused deductions only added to existing operating losses.

The new tax law changed depreciation schedules by permitting firms faster tax write-offs—known as accelerated depreciation, or ACRS—of equipment purchases. The new ACRS schedule benefits profitable firms by reducing their taxes and, thus, increases working capital for more business expansion. At the same time, however, ACRS does not help unprofitable or marginally profitable firms which cannot take advantage of accelerated depreciation. To help such firms, Congress enacted safe harbor leasing.

SAFE HARBOR LEASING

In tax theory, a safe harbor means that a tax benefit will be granted without challenge if the taxpayer applying for the benefit meets specified requirements. This taxpayer has sailed into a "safe harbor."

Last year's tax bill provided a safe harbor for determining whether a transaction was a lease or a financing arrangement. To qualify for the safe harbor, five easily satisfied conditions had to be met. The conditions are so loose that virtually any leasing transaction qualifies as a lease. . . regardless of who owned what property for what purpose under what terms. For example, the new law permits a "lessor" to receive the tax benefits associated with equipment ownership even though he may not in fact actually own the equipment!

The bottom line is this: Safe harbor repeals what had been a fundamental principle of tax law. Formerly the substance of a transaction rather than its form determined federal income tax treatment. It also used to be a basic rule of tax law that a transaction must serve some general business purpose aside from merely reducing taxes. Because leasing is a transferability provision, many of the transactions will have no business purpose other than tax reduction. In other words, safe harbor permits a corporation unable to use its tax deductions and credits to sell them to a corporation that can . . . even though property never changes hands and no new business investment occurs.

Consider the following hypothetical example: Seller Corporation cannot use the tax benefits associated with a $10 million equipment purchase. It sells the tax benefits (ACRS deductions and investment tax credits) to Buyer Corporation for $2 million cash plus a 9-year note for $8 million. Buyer Corporation then leases the equipment back to Seller Corporation with lease payments equal to the note payments. Thus, no cash changes hands after the intitial transaction. After 9 years, Seller Corporation purchases the equipment for as little as $1. The Seller Corporation retains titled ownership to the equipment . . . so all that really changes hands is tax benefits for up-front cash.

In this example, who got what? Buyer Corporation received a $1 million investment tax credit and a 5-year write-off of the equipment under ACRS. Seller Corporation gets $10 million in equipment for $8 million. The reduction in equipment cost is actually provided by the U.S. Treasury . . . and ultimately the American taxpayer, yet no actual new business investment actually occurred.

The question comes down to this: Should other taxpaying Americans (who earn an average of $19,000) have his tax money foot the tax bill to help some large corporation reduce its tax liability through a paper transaction of absolutely no economic substance?

In my judgment, the answer is . . . no!

This is not idle or abstract tax theory. Safe harbor adversely affects real-world business decisions.

The classic example of this exists in the airline industry. Some airlines seek to use cash made available through safe harbor leasing to help buy new fuel-efficient, modern, quiet, safer planes. Undoubtedly these equipment purchases will create new jobs in airplane manufacturing companies, and make the industry more competitive. But other airline companies point out that the industry is already plagued by excess seat capacity, and the last thing needs is more planes. These firms also rely on used planes that do not qualify for safe harbor leases. So, in essence, with enactment of safe harbor leasing, Congress has said it favors one company over another in this economically distressed industry . . . and that if favors large business over smaller, newer firms.

That should not be government's role.

Safe harbor leasing advocates argue that leasing is the principal means by which ACRS benefits are distributed even-handedly and efficiently between profitable and unprofitable companies, that safe harbor is not a radical new departure from the old law, that the press has distorted the impact of safe harbor leasing and that safe harbor does not prop up inefficient companies.

These and other arguments simply don't hold water, in my opinion. Here is why safe harbor leasing should be repealed.

Safe Harbor Has Been Abused

The cases cited earlier—GE, Amoco, Occidental Petroleum and Others—reflect the significant potential for abuse of safe harbor.

Safe Harbor Leasing Subsidizes Unprofitable Investments

Dr. Alan Greenspan equates leasing with food stamps for undernourished corporations. The reality is even harsher than that because leasing causes corporations to misallocate their resources for purely tax-induced reasons.

Even worse, leasing permits a corporation that pays no tax to receive the cash value of its investment tax credits and depreciation deductions.

Incrediable though it may seem, six corporate supporters of safe harbor leasing testified before the House Ways and Means Committee that they would rather see leasing maintained than the corporate income tax repealed?

Safe Harbor Skews Investment Toward Depreciable Assets

Safe harbor does not apply either to intangible drilling costs or other intangible assets. Therefore, leasing makes investment in plant and equipment more attractive than drilling for oil, or investment in research and development.

Safe Harbor Distorts the Neutrality of the Tax Law

The goal of tax policy is to equalize the cost of capital for all businesses. Yet leasing permits nontaxable companies to sell their tax benefits, and pay a far lower effective tax rate than their taxable competitors.

Safe Harbor Leasing Is Unavailable to Small Businesses

To quote Mike McKevitt of the National Federation of Independent Business: "Just as with many of our nation's well intentioned social welfare programs, this big business welfare program is too expensive, and in fact, counterproductive. Take this money (from safe harbor) . . . and reduce the deficit . . ."

Safe Harbor Leasing Distorts Profits

Because cash received in safe harbor leases is treated as gain, a shareholder will be misled as to corporate profitability from operations. In fact, some lease brokers report that the only reason some major traansactions are being done is to provide a "kick" to earnings.

Safe Harbor Leasing Will Be Expanded If Not Repealed

Because leasing violates so many fundamental tax principles, it will be impossible to limit its application. For example, efforts are already underway in Congress to extend safe harbor leasing to tax-exempt institutions, municipal fire departments and to cover intangible drilling costs.

Safe Harbor Leasing Undermines Public Confidence in the Tax System

To quote the Joint Tax Committee's "Analysis of Safe Harbor Leasing": "A fundamental principle of U.S. tax policy has been that the tax system should be structured so as to appear to be as fair as possible. Studies show that voluntary compliance with the tax laws declines rapidly to the extent people believe the tax system to be inequitable . . . In the months after its enactment, the safe harbor leasing provisions appear to have been the subject of widespread public perceptions of unfairness, perceptions which could be injurious to a tax system based on voluntary compliance."

Safe Harbor Repeals Fundamental Principles of Tax Law

A safe harbor lease does not have to have any economic substance as a lease. It is a paper transaction . . . a mere transfer of benefits. It used to be that a lease had to show a positive cash flow as well as profit, and the lessor had to actually own the equipment as well as have a minimum investment in the property. Safe harbor leasing repealed these sensible rules.

For all of these reasons and more, Congress should repeal safe harbor leasing.

ACQUISITIONS AND MERGERS

The oft-repeated rule that those who don't remember the past are condemned to repeat it should be kept in mind as Congress considers the acquisitions and mergers (A–M) provisions contained in this bill.

The A–M provisions seek to reform abuses that have led to tax-induced corporate acquisitions and mergers. There has been a flurry of news stories in recent days about the Mobil-Esmark and U.S. Steel-Marathon mergers which were in part brought about by astute manipulation of current tax law. But the provisions contained in this bill that seek to correct these abuses may be so broad and far-reaching that they may adversely affect every corporate acquisition, merger or liquidation, no matter how legitimate. There has been little serious study of these provisions, and their impact on business decisionmaking is simply not known. The Senate has not yet held hearings on this legislation, and in fact this bill was *introduced* for only two days before the Senate Finance Committee included it in this tax bill.

This rush to judgment calls to mind the carryover basis controversy of 1976. In similar circumstances, Congress that year was working on a major revision of tax law. Included in the final bill was a provision on which there had been no hearings, and precious little debate. This provision was the so-called carryover basis rule . . . a new and controversial method for calculating the basis of inherited property.

After Congress enacted the carryover basis provision, a storm of controversy arose. Lawyers everywhere claimed this was the most unfair and unworkable provision ever enacted in the tax law. What followed was the first in a series of laws that changed the effective date for implementing carryover basis. Finally, in 1979 Congress concluded what tax lawyers knew in 1976 . . . the carryover basis should be repealed.

Congress should not make the same mistake twice, but I regret it may do so in the current acquisitions and mergers provisions in this legislation. To quote Jack Nolan, Chairman of the Tax Section of the American Bar Association:

> This bill would make major changes in the tax treatment of corporate liquidations, corporate acquisitions of stock or assets, and carryovers in corporate acquisition transactions; such changes are designed primarily to deal with some specific corporate acquisition techniques that have come to light. In doing so the bill would affect a broad range of corporate transactions that extends far beyond these specific problems. There is considerable doubt whether such far-reaching changes are justified or advisable; they could impose severe hardships on smaller, closely-held corporations.
>
> It may well be that the specific problems at which this bill is aimed could be resolved by less Draconian changes, while reserving for more thorough but accelerated study, the deeper issues presented.
>
> These questions are matters as to which the views and experience of the practicing bar are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the Congressional tax staffs, the Treasury Department, and the practicing bar acting through its institutions such as the Section of Taxation of the American Bar Association. Accordingly, I urge you to hold further hearings after the tax bar had had more opportunity to consider the issues and formulate its views. I assure you that, if such an opportunity is given, the tax bar will respond in timely and objective fashion.

These concerns were echoed by Gilbert Bloom of Peat, Marwich and Mitchell:

> This Bill would make the most profound changes in Subchapter C of the Internal Revenue Code in 28 years and would overturn principles established in the 1930's. Therefore, these proposed changes warrant very careful study and analysis. However, since there has been only a ten-day period from the availability of this Bill until written comments were due, my comments today can only be broad preliminary observations.

Since the Finance Committee approved this section of the bill, it has been told that the new provisions could lead to double taxation of appreciated property used to redeem stock in a partial liquidation, and that in some cases there could even be a triple tax if the liquidating business used LIFO accounting, and is thereby subject to LIFO reserve recapture rules. Particularly affected will be closely held, family-owned business.

The Senate Finance Committee will hold its first hearings on this legislation July 15th. Until the full effects and consequences of this legislation are known and considered, Congress should proceed with the utmost caution.

WILLIAM L. ARMSTRONG.

XII. SUPPLEMENTAL VIEWS OF SEN. HARRY F. BYRD, JR.

I voted in favor of the spending reductions approved by the Finance Committee.

I cast my vote against the tax increase package in the Committee. The tax package was not presented to the Committee until the morning of July 1, 1982, when the Committee began its consideration of revenue-raising options. The Committee's deliberations ended in the early morning hours of July 2, 1982, just sixteen hours after they had begun.

I shall continue to study the provisions of the bill and shall keep an open mind as to how I shall vote on it and on any amendments that may be proposed in the Senate.

HARRY F. BYRD, Jr.

XIII. MINORITY VIEWS OF SENATORS LONG, BENTSEN, MATSUNAGA, MOYNIHAN, BOREN, AND MITCHELL

The tax increase provisions of the reconciliation bill reported by the majority of the Finance Committee represent the largest tax increase ever recommended in a single piece of legislation by the Committee. Notwithstanding the significance of this legislation, the bill was put together in a way that has no precedent in the experience of any present member of the Committee.

The reported bill would increase taxes by an estimated $21 billion in fiscal year 1983, $34 billion in fiscal year 1984, and $43 billion in fiscal year 1985.

The President proposed some of the provisions in the reported bill, or different provisions concerning the same subject matter, in late January, with details becoming available one month later. Senators Dole and Grassley announced thier proposals relating to taxpayer compliance on March 5 and introduced a bill on this subject shortly thereafter. However, descriptions of most of the remaining provisions were first printed, some only in outline form, in a staff pamphlet which was issued June 15—just two weeks before the day the Committee began and ended its deliberations on the tax increase provisions.

The Republican members of the Committee made the decisions on the provisions to be included in the bill within a few days in closed meetings in which only they were permitted to participate. The decisions made in these closed meetings did not become public until 9:00 a.m. on July 1, as the Committee opened its meeting on the tax increase provisions. The bill was ordered reported sixteen hours later, after the Committee met almost continually during the morning, afternoon, and evening.

This means that taxpayers affected by the various proposals described in the staff pamphlet generally had only two weeks to make their views heard by Committee members before the Committee acted to increase their taxes.

It means that taxpayers affected by provisions crafted in the closed meetings attended only by Republican Committee members has no time to make their views known because action on the tax increase provisions began and ended on the same long day, July 1.

It means that whether a Committee member voted for or against a particular tax increase provision, in most cases he made that decision without having all the information he would need to understand the impact of that decision on his constituents and on taxpayers in other States.

It means that most of the decisions were made in only broad outline fashion, with the staff attempting to fill in the details in the course of drafting sessions after the bill was ordered reported.

For reasons best known to the Republican Committee members, they decided not to invite Democratic Committee members to participate in putting together the tax increase package reported by the Committee. Democratic Committee members first saw the proposed package only when it become public information—at 9:00 a.m. on July 1, when the Committee session began on the tax increase provisions. Sixteen hours later, all Republican Committee members voted in favor of the tax increase package; all Democratic members voted against the package.

The Democratic Committee members did not caucus before the Committee session in order to arrive at a common position; and when the Democratic members met during the lunchtime recess on July 1, no pressure was brought to bear on any individual either to vote for or against the tax increase package or any separate provision in it.

The fact that all Democratic members voted against the tax increase package showed that each member for his own reasons thought that the package should not become law. Such a result would hardly have been likely had Democratic members been accorded the opportunity of becoming fully involved in the decision-making process.

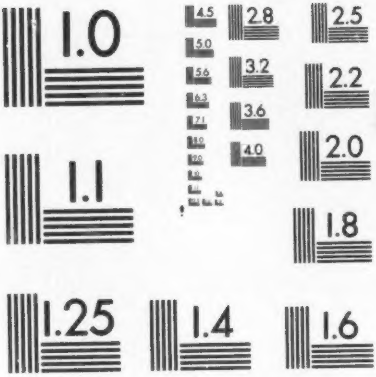
Although the reported bill represents the largest tax increase bill ever recommended to the Senate, the Senate's ability to consider its merits will be severely constrained. It is being reported as a reconciliation bill. Senate debate will be limited to twenty hours. Only germane amendments may be offered, which means that alternative approaches to tax increases may not be offered unless a majority of the Senate is willing to grant a waiver permitting them to be offered. The effect of this is that the decisions made by the Republican members of the Finance Committee in their own closed sessions will, unless the rules are waived, be the only provisions the Senate is permitted to vote on. While there are individual provisions of the bill that individual Democratic Committee members can support, we recommend that the bill as reported be defeated.

RUSSELL B. LONG.
LLOYD BENTSEN.
SPARK M. MATSUNAGA.
DANIEL PATRICK MOYNIHAN.
DAVID L. BOREN.
GEORGE J. MITCHELL.

○

No. M-107

ONE DECIMETER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